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JU 11.7/2:1986-427

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T. C. Memo. 1986-427

UNITED STATES TAX COURT

ERNEST S. KLAPPENBACH AND JANET M. KLAPPENBACH, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13023-78. Filed September 11, 1986.

Ernest S. Klappenbach, pro se.

Osmun R. Latrobe, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined a deficiency of $2,008.08 in petitioners' income tax for 1972. The sole issue for decision is whether petitioners are entitled to a charitable contribution deduction under section 170[1] for a payment made to a retirement home.

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1 All section references are to the Internal Revenue Code of 1954, as amended during the year in issue, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure.

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FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation and exhibits attached thereto are incorporated herein by reference.

Petitioners, Ernest S. and Janet M. Klappenbach, resided in Tulsa, Oklahoma at the time the petition herein was filed. Ernest Klappenbach ("petitioner") is an author and during 1972 worked for an oil and gas trade magazine.

In 1972, petitioner began to search for a retirement home for his mother, who was then living alone in Chicago. Petitioner looked at approximately twenty facilities, one of which was University Village (the "Village"), an Oklahoma corporation sponsored by and affiliated with Oral Roberts. The Village at that time was constructing a facility in Tulsa and had completed the first phase of its residential units. The Village offered a wide variety of living arrangements and accommodations including cottages; large and small apartments, with or without kitchens; an infirmary; recreational and social facilities; and a community dining hall.

Residents at the Village paid a monthly service charge that covered current operating costs, including meals, housekeeping, and transportation. Construction of the buildings was financed with borrowed funds, but they were ultimately paid for with "sponsorship gifts" or "donations." These gifts were solicited from residents and prospective residents as well as their relatives and friends. The amounts solicited depended upon the

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size and type of unit selected by the resident. In 1972 the sponsorship gift solicited for an apartment with one bedroom and no kitchen was $15,500. A resident was not required to make a sponsorship gift. However, if they did not, the Village would "endeavor" to find a sponsor for them.

As of March 1975, the Village had housed a total of 455 residents, including the then current occupants and 19 residents who had moved out. Of all the residents admitted to the Village, 63 had made no sponsorship gift or a gift of less than the suggested amount, but 16 residents had made a gift of greater than the suggested amount. Of the 19 residents who moved out prior to March 1975, 12 received either a full or partial refund of their sponsorship gift.

Petitioner chose the Village as a retirement home for his mother after meeting with two of the Village's representatives. During these meetings sponsorship gifts were discussed and petitioner was given literature about such gifts.

Subsequently, petitioner's mother applied for admission to the Village, and in July 1972 her application was accepted. In September 1972, she moved into a Village apartment which had one bedroom and no kitchen.

At about the same time that petitioner's mother moved to the Village, she gave him a check in the amount of $10,500. The check was drawn on a trust account which had been established by

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petitioner's father during his lifetime for the support of petitioner's mother during her lifetime, with the remainder going to petitioner and his sister.

Petitioner deposited the $10,500 check in his personal account and on October 10, 1972, gave the Village a check on his account for $10,500, which was designated as representing a $5,500 sponsorship gift from petitioner and a $5,000 sponsorship gift from petitioner's sister. On the same day, the mother at petitioner's request executed another check on her trust account in the amount of $5,000 which was payable to the Village and represented the balance of the $15,500 in sponsorship gifts which had been suggested by the Villages' representatives for the mother's apartment.

Petitioner's mother lived in the apartment until she became ill approximately five months later. At that time she was moved to the infirmary, where she stayed until her death one year later.

On the 1972 return, petitioner claimed a deduction of $5,500 for a charitable contribution to the Village. In his notice of deficiency, respondent determined that petitioner's payment of the $5,500 to the Village did not qualify for deduction as a charitable contribution under section 170. In years prior to and subsequent to 1982, petitioner's charitable contributions averaged about $500 to $700 per year, with his highest being $1,000.

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OPINION

Section 170 allows a deduction for charitable contributions, which the statute defines as gifts made to a specified class of organizations. In this case the parties agree that the Village is qualified to receive charitable contributions under section 170. They disagree, however, as to whether the disputed transfer constituted a gift. Although different tests have been applied in determining whether a given transfer qualifies as a contribution under section 170, [see Haak v. United States, 451 F. Supp. 1087, 1090 (W.D. Mich. 1978)] under Golsen v. Commissioner, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971), in this case we must apply the test used by the Tenth Circuit Court of Appeals, in Dowell v. United States, 553 F.2d 1233 (10th Cir. 1977). There the court, citing Commissioner v. Duberstein, 363 U.S. 278 (1960), stated that "a gift is a voluntary transfer of property without consideration, and * * * if a payment or transfer of other thing of value is made in anticipation of a benefit other than the personal satisfaction of having performed the act of generosity, the transaction is not a gift." 553 F.2d at 1238.

From the record as a whole we are satisfied that the $5,500 paid by petitioner to the Village was not a gift but more in the nature of rent for his mother's use of the apartment. Under the surrounding circumstances the payment cannot be viewed as a voluntary and gratuitous contribution motivated by the satisfaction which would flow from the performance of a generous

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act. Instead, it was induced by the benefits which petitioner had been led to believe he and his mother would derive from her having a place in which to live and be taken care of for the rest of her life. Consequently, under the rule laid down in Dowell the transfer did not constitute a gift by petitioner.

We recognize that in Dowell the court allowed a charitable contribution on facts somewhat similar to those here. In Dowell, however, the court stressed that it was considering only the particular donor and the circumstances involved in that case. Dowell v. United States, 553 F.2d at 1238. Moreover, the court noted that it was bound by the trial court's conclusion that there the donor intended to make a gift. This case involves a different taxpayer and a different set of circumstances from which we have concluded that the taxpayer did not intend to make a gift. Consequently while we agree with and adopt the reasoning used in Dowell it leads us to a different conclusion on the facts before us.

Decision will be entered for respondent.

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T. C. Memo. 1986-428

UNITED STATES TAX COURT

EVANGELOS KAIRIS AND HELEN KAIRIS, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17783-84. Filed September 11, 1986.

Alan R. Harter, for the petitioner.

Kenneth A. Burns, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined the following deficiencies in and additions to petitioners' income taxes:

Year	Deficiency	Addition to Tax Section 6653(a)[1]
1980	$ 6,997.00	$ 349.85
1981	6,091.00	304.55, plus 50% of interest on underpayment of $6,091.

[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

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The issues for decision are (1) whether petitioners' failure to comply with respondent's toke compliance program relieves respondent of his obligations to petitioners; (2) whether respondent correctly determined petitioners' 1980 and 1981 tip income; (3) whether petitioners are entitled to deductions for certain gambling losses; and (4) whether petitioners are liable under section 6653(a) for an addition to tax for negligence or the intentional disregard of rules and regulations.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation and attached exhibits are incorporated herein by reference.

Petitioners, Evangelos and Helen Kairis, husband and wife, resided in Las Vegas, Nevada at the time they filed their petition. They filed joint income tax returns for 1980 and 1981 with the Internal Revenue Service Center in Ogden, Utah.

During 1980 and 1981, Evangelos worked 1,925 and 2,063 hours, respectively, at Caesar's Palace (Caesar's). Except during a month-long culinary strike in 1980, he was employed as a twenty-one dealer. During the strike, he worked as both a cook and a maid for which he received only wages. As a twenty-one dealer, Evangelos received an hourly wage and was permitted to keep "tokes." A toke is a casino chip given by a patron to a dealer as a tip or placed by the patron as a bet for the dealer. All tokes received by twenty-one dealers during each 24 hours

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were pooled and divided among the dealers according to number of hours worked. Evangelos did not keep any record of his toke income for the years in issue. However, he reported tokes to Caesar's and on his tax returns of $7,914.00 and $9,170.00 for 1980 and 1981 respectively. Evangelos received wages in the respective amounts of $10,132.61 and $12,199.94 in 1980 and 1981.

During 1980, Helen Kairis was employed as a twenty-one dealer by various casinos. She worked 635 hours and received wages of $3,307.37. For 1980, she reported tips totaling $150.00 to her employers and on her income tax return. Helen also received $1,438.00 of unemployment compensation.

During 1981, Helen Kairis was employed by the Nob Hill Casino as a twenty-one dealer. She reported wages and tips of $1,269.00 on her 1981 income tax return.

Evangelos is a self-described "degenerate" gambler. When not working he regularly visits other casinos and bets on any game available. In 1980, his net losses were less than $1,000. However, in 1981 his net losses were between $12,000 and $13,000.

In April 1982, Evangelos became a participant in respondent's toke compliance program. In general terms, this was a discretionary program under which the Internal Revenue Service agreed not to audit a dealer's returns for years prior to 1982 if the dealer accurately reported his tokes for 1982 to his employer on a monthly basis and on his income tax return. At the trial Evangelos admitted that he did not begin to fully report his toke receipts to Caesar's until October 1982 and that he did not

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report his entire toke income on his return for 1982. Due to his failure to fully comply with the program, respondent commenced an audit of his 1980, 1981, and 1982 income tax returns.[2]

Respondent determined that Evangelos had unreported toke income of $18,554.75 for 1980 and $19,196.25 for 1981.[3] The determination was based upon an examination by respondent's agents of the daily receipts for 1982 reported by several of Caesar's dealers.[4] From these reports respondent's agents first determined daily modes, the total daily receipts most frequently reported by the dealers for each day of the year. The daily modes were then averaged on a monthly basis and from the monthly averages an annual daily average (eight-hour shift) of $110 was determined. The daily figure was divided by eight in order to arrive at an average of $13.75 per hour. The hourly rate was multiplied by the number of hours worked by petitioner in 1980 and 1981 in order to determine petitioner's total toke receipts for 1980 and 1981.

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2 Although 1982 was covered by the audit, it is not at issue in this case.

3 Respondent conceded that Helen Kairis' toke receipts were correct as reported.

4 Respondent's computation is as follows:

Year	Hours Worked	Toke Rate Per Hour	Total Tokes	Toke Income Reported	Toke Income Unreported
1980	1,925	$ 13.75	$ 26,468.75	$ 7,914.00	$ 18,554.75
1981	2,063	13.75	28,366.25	9,170.00	19,196.25

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OPINION

Toke Compliance Program

Petitioners contend that the audit of their 1980 and 1981 returns should not be permitted because Evangelos complied with the toke compliance program insofar as he understood it. Respondent, however, contends that the failure of Evangelos to accurately report his toke receipts to Caesar's and on petitioners' joint tax return for 1982 relieves respondent of his promise not to audit the prior years. We agree with respondent.

Petitioners admit that Evangelos failed to comply with the program. They contend, however, that his failure was due to a misunderstanding of the program, but they do not contend that the misunderstanding was caused by respondent. Under these circumstances it is apparent that respondent was not responsible for Evangelos' failure to comply with the program. Consequently, the audit of petitioners' 1980 and 1981 tax returns was proper.

Unreported Tip Income

Tokes or tips are includable in gross income under section 61 [Catalano v. Commissioner, 81 T.C. 8, 13 (1983), affd. without published opinion sub nom. Knoll v. Commissioner, 735 F.2d 1370 (9th Cir. 1984); Olk v. United States, 536 F.2d 876 (9th Cir. 1976)] and all taxpayers are required to keep sufficient records to enable respondent to determine their correct tax liability. Section 6001. If a taxpayer receives income from tips, the required records include an accurate and contemporaneous diary of

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such income. Section 1.6001-1(a), Income Tax Regs. Furthermore, under section 6053 and its regulations, the employee is required to report the correct amount of such income to his or her employer.

Evangelos did not keep any record of his tip income. In the absence of such records, respondent is authorized by section 446 to compute Evangelos' tip income in accordance with any method which, in his opinion, clearly reflects such income. Sutherland v. Commissioner, 32 T.C. 862 (1959). Respondent has great latitude in adopting a method for reconstructing such income. Catalano v. Commissioner, 81 T.C. at 13; Giddio v. Commissioner, 54 T.C. 1530, 1533 (1970). The method is sufficient if the reconstruction is reasonable in light of all of the surrounding circumstances. Catalano v. Commissioner, 81 T.C. at 13; Schroeder v. Commissioner, 40 T.C. 30, 33 (1963). Petitioners have the burden of proving that respondent's determination is erroneous. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Petitioners contend that respondent's calculation is erroneous in two respects. First, petitioners argue that respondent's calculation failed to take into consideration the month during which Evangelos received no tokes while he worked as a maid and cook at Caesar's. Second, they contend that respondent's use of the figures for 1982 is not compatible with 1980 and 1981, the years in question.

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We agree with petitioners' first contention that respondent's determination for 1980 must be adjusted for the month in which Evangelos received no tokes from Caesar's patrons.

As to petitioners' second contention, it is noted that respondent's reconstruction need only be reasonable in light of all of the surrounding circumstances. Catalano v. Commissioner, supra; Schroeder v. Commissioner, supra. From the record before us it is apparent that respondent, in a thorough and professional manner, conducted an extensive examination of Caesar's toke records for 1982. While the determination might have been more accurate if records for 1980 and 1981 were available, no such records were prepared for these years. Consequently, in the absence of figures for 1980 and 1981, the use of the figures for 1982 is not only justified but their use obviously produces the most correct result possible under all of the surrounding circumstances. This is especially true where, as here, the record contains no evidence tending to indicate a change in the toke rate from 1980 and 1981 to 1982. Catalano v. Commissioner, supra.

We conclude, therefore, that respondent's determination of unreported tokes for 1980 and 1981 should be sustained in all respects except that respondent's determination of unreported toke income for 1980 is reduced by $2,205.78, being one-twelfth of the total hours worked by petitioner in 1980 times the $13.75 toke rate.

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Gambling Losses

Petitioners contend that a portion of the toke income determined by respondent in both 1980 and 1981 is attributable to wins from Evangelos' gambling transactions and, therefore, that portion should be offset by the wagering lcsses which he suffered in 1980 and 1981. The tokes, however, were received in exchange for the services which Evangelos performed for Caesar's patrons and were the direct result of his employment as a dealer rather than from gambling transactions. As such, the tokes constitute compensation for personal services performed and cannot be offset by gambling losses. Bevers v. Commissioner, 26 T.C. 1218, 1220-1221 (1956).

Addition to Tax

Respondent's determination that petitioners are liable for the addition to tax under section 6653(a) because of negligence or intentional disregard of rules and regulations is presumptively correct and petitioners have the burden of proving that the determination is erroneous. Catalano v. Commissioner, supra; Rule 142(a).

Petitioners failed to maintain accurate records of Evangelos' tip income as required by section 6001 and the regulations issued thereunder and the reccrd before us contains no evidence which tends to justify their failure to do so.

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Therefore, respondent's determination with respect to the addition to tax provided by section 6653(a) is sustained. Meneguzzo v. Commissioner, 43 T.C. 824, 836 (1965).

Decision will be entered under Rule 155.

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T. C. Memo. 1986-429

UNITED STATES TAX COURT

FOUNDATION STEEL AND WIRE, INC., Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

FOUNDATION STEEL AND WIRE, INC. AND BURNS,
MORRIS AND STEWART, INC., Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 23794-81, 23933-81. Filed September 11, 1986.

Dougal C. Pope, for the petitioner.

David W. Johnson and Sheri Wilcox, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GOFFE, Judge: The Commissioner, in the statutory notices of deficiency, determined deficiencies in petitioner's Federal income tax for the taxable years ended April 30, 1977, and

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April 30, 1978[1] in the following amounts and additions to tax under section 6653(b)[2] as follows:

Docket Number	Taxable Year	Deficiency	Addition to Tax Under Sec. 6653(b)
23794-81	1977	$411,393.43	$205,696.72
23933-81	1978	251,232.06	125,616.03

The deficiencies determined in the statutory notice of deficiency for the taxable year 1978 covered adjustments to the liability of the parent corporation, Foundation Steel and Wire, Inc., and Burns, Morris and Stewart, Inc., which filed a consolidated return. Respondent was granted leave to file an amended answer in which he asserted increased deficiencies in tax and addition to tax under section 6653(b) for the taxable year 1978 in docket No. 23933-81. The amendment resulted in total deficiencies in tax and addition to tax under section 6653(b) of $422,422.08 and $211,211.04, respectively. After concession by petitioner of the deficiencies in income tax determined in the statutory notices of deficiency, the issues remaining for decision are whether Burns, Morris and Stewart, Inc., and Foundation Steel and Wire, Inc.,

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1 For convenience, we will refer to each of petitioner's taxable years by the calendar year within which it ended, i.e., the taxable year ended April 30, 1977, will be referred to hereafter as the taxable year 1977.

2 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect for the relevant years, and all Rule references are to the Rules of Practice and Procedure of this Court.

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were eligible to file a consolidated return for the taxable year 1978, and whether petitioner is liable for additions to tax under section 6653(b) for fraud.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulations of facts and accompanying exhibits are so found and incorporated by reference.

Foundation Steel and Wire, Inc. (Foundation Steel), and Burns, Morris and Stewart, Inc. (Burns), had their principal place of business in Houston, Texas, at the time the petitions in this case were filed. Petitioner's books and records were maintained and the income tax returns were prepared on the accrual method of accounting during the taxable years at issue. Petitioner used a fiscal year ending on April 30th. Foundation Steel filed a corporate income tax return for the taxable year 1977 and a consolidated corporate income tax return with Burns for the taxable year ended 1978.

Foundation Steel was incorporated under the laws of Texas on January 8, 1971. It is in the business of manufacturing and selling steel and wire products. According to the corporate income tax returns filed for the taxable years 1977 and 1978, the stock in Foundation Steel was held as follows:

Douglas Stewart	80 percent
Jack Burns	5 percent
Walter Morris	15 percent

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Its officers during the taxable years at issue were:

Douglas Stewart	President
Jack Burns	Vice-President, Secretary- Treasurer
Walter Morris	Vice-President

Burns was incorporated under the laws of Texas on March 14, 1977. Its business was the manufacture of pattern material for resale.

During the taxable years at issue, the officers of Burns were:

Douglas Stewart	President
Joe Hearndon	Vice-President
Jim Dailey	Vice-President

The articles of incorporation of Burns provide, in part, that Burns is authorized to issue 5,000 shares of stock. On April 2, 1977, Burns stock certificate number 1 was issued to Douglas L. Stewart for 750 shares. Stock certificates 2 through 15, inclusive, were issued to Douglas L. Stewart, Trustee, who held the shares in trust for various employees of Foundation Steel and Burns. These latter stock certificates were issued pursuant to the terms of trust agreements concurrently executed on April 2, 1977, by Douglas L. Stewart and the beneficiary/ employees. Burns did not issue any other shares of stock nor were any shares of stock transferred during the period between April 2, 1977, and the end of the taxable year 1978.

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The trust agreements were identical except for the names of the beneficiaries who were all employees. The stock was to be held in escrow pending completion of a term of employment of 5 years, at the end of which time the stock would be transferred from Douglas L. Stewart, trustee, to the named beneficiary/employee. The transfer would also occur if the beneficiary/employee died during the 5-year period. If an employee failed to satisfy the terms of employment, the trust terminated as to that employee and the ownership of the stock became owned individually by Douglas L. Stewart. Neither Foundation Steel nor Burns were parties to or beneficiaries under the trust agreement. Under the terms of the trust agreements, there was no circumstance by which Foundation Steel could acquire ownership of any of the shares of stock held in trust by Douglas L. Stewart. Douglas L. Stewart owned 100 percent of the stock of Burns during the period April 2, 1977, to the end of the taxable year 1978.

Foundation Steel earned $296,884.73 in gross receipts from the sale of merchandise during the taxable year 1977 which was not deposited into either its general or payroll account nor was it reported on its Federal income tax return for that year. It earned $142,897.30 in gross receipts from the sale of merchandise during the taxable year 1978 which was not deposited into either its general or payroll account nor was it reported on its Federal income tax return for that year. The unreported earnings

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consisted of bank checks that were either cashed at banks in the area or deposited into the general bank account and recorded on the general ledger as loans rather than income.

Robert D. Pearce, C.P.A., prepared petitioner's income tax returns for the taxable years at issue. For the taxable year 1977, Pearce prepared the return from the bank statements, deposit slips, and cancelled checks of the general bank account and the payroll account. In addition, he used the general ledger. Douglas Stewart told him orally the figures to use for cost of goods sold, beginning and ending accounts receivable, and beginning and ending inventory. Pearce used the same information plus the workpapers and general journal of Burns to prepare the return for the taxable year 1978. The checks of Foundation Steel were signed either by Douglas Stewart or by Jack Burns.

Cost of goods sold for the taxable years 1977 and 1978 to the extent of $496,234.84 and $229,228.18, respectively, were payments made to Star Associates. Ralph Block, who died on April 27, 1982, represented that he was the sole owner of Star Associates. There was no listing for Star Associates in the Houston telephone directory for the years 1976, 1977, and 1978. Star Associates was not incorporated as a corporation in the State of Texas nor did it file an assumed name certificate with the State of Texas. Star Associates did not file tax returns for the taxable years at issue.

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Ralph Block filed individual income tax returns for his taxable years 1977, 1978, and 1979 and amended income tax returns for his taxable years 1976, 1977, 1978, and 1979. The total of the checks from Foundation Steel deposited to the account of Star Associates for the calendar years 1976, 1977, and 1978 were identical to the totals reported as income by Ralph Block on attachments to his amended income tax returns for his taxable years 1976, 1977, and 1978, with the explanation that the amounts were handled by Ralph Block on behalf of an undisclosed principal.

Star Associates performed no services and sold no goods to Foundation Steel during the taxable years at issue. The payments made to Star Associates by petitioner were used primarily to purchase assets for or to make loans to Douglas L. Stewart and his friends, family, and associates. Personal loans were also made by Ralph Block in the total amount of $22,500. The payments by petitioner to Star Associates were intended to finance these personal needs of Douglas L. Stewart as well as to divert taxable income away from petitioner.

Two unnumbered checks of Star Associates and three checks of Star Associates numbered 116, 117, and 118 aggregating $106,444.69 were used to purchase five cashier's checks made payable to M.L. Johnson in August of 1976. M.L. Johnson is the maiden name of Myra L. Stewart, Douglas Stewart's ex-wife. Four of the cashier's checks made payable to M.L. Johnson were deposited into the joint bank account of Mr. and Mrs. Douglas L.

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Stewart. The fifth cashier's check was deposited on September 11, 1976, into a bank account owned by Myra Stewart. Two checks of Star Associates, numbered 128 and 138, aggregating $73,625.08 were used to purchase yet two more cashier's checks made payable to M. Stewart, both of which were deposited in February or March 1978 into bank accounts belonging to Myra Stewart. Collectively, the seven cashier's checks in the total amount of $180,069.77 that were made payable to M.L. Johnson or M. Stewart were paid to Myra Stewart pursuant to her divorce settlement with Douglas Stewart.

D.K. (Debra) Kuehn was an acquaintance of Douglas Stewart who was employed as a bartender before her nominal employment by Foundation Steel. She was in fact hired by Douglas Stewart to take care of rental property owned by him personally and to take care of other minor personal errands. Although Debra Kuehn performed no services for either petitioner, Foundation Steel paid her salary and also paid her personal expenses, including the purchase of an automobile and payment of tuition for her son. An unnumbered check of Star Associates in the amount of $10,000 was used to purchase a cashier's check made payable to D.K. Kuehn, which check was cashed on June 3, 1976. The check of Star Associates numbered 122 in the amount of $18,500 was used to purchase a cashier's check made payable to Stewart Title Guaranty Company, which is an entity unrelated to Douglas Stewart. Douglas Stewart lent the $18,500 represented by this cashier's

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check to Debra Kuehn to use as a down payment on a house at 12214 Timberlake in Houston. Debra Kuehn purchased the property and then conveyed it to Douglas Stewart.

On June 2, 1978, the following properties, all of which were located in Houston, were conveyed by Douglas Stewart to his son, also named Douglas L. Stewart,[3] and to his daughter, Susan Stewart Crouse, in undivided one-half interests: 1009, 1009-1/2, and 1011 Enid Street; 1809 Harvard Street; 1228, 1228-1/2, 1230, 1230-1/2 and 1232-1/2 Nicholson Street. Each of the properties had been purchased by Douglas Stewart subject to mortgages that were paid by funneling money from Foundation Steel through Star Associates to the various title companies or individuals.

The down payment on the property located at 1009, 1009-1/2, and 1011 Enid Street in Houston originated with funds paid to Star Associates by Foundation Steel. Star Associates issued check number 121 dated September 14, 1976, in the amount of $36,784.56 payable to D.K. Kuehn. Debra Kuehn did not earn these funds. The check was actually used to purchase a cashier's check payable to Stewart Title Company that was used as a down payment on property located at 1009, 1009-1/2, and 1011 Enid Street in Houston. The check of Star Associates numbered 157 dated April 24, 1978, in the amount of $45,425 payable to E.W. and J.E. Wright was used to purchase a cashier's check payable to the same

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[3] Father and son both have the name Douglas L. Stewart. All references to Douglas Stewart, Douglas L. Stewart, D. Stewart, and D.L. Stewart refer to the father, President of Foundation Steel, unless preceded by the phrase "his son."

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two individuals. This check was used to pay off the existing mortgage on the property located at 1009, 1009-1/2, and 1011 Enid Street. On June 2, 1978, Douglas Stewart conveyed an individed one-half interest to his son, Douglas L. Stewart, and the remaining undivided one-half interest to his daughter, Susan Stewart Crouse.

The mortgage on the property at 1809 Harvard Street in Houston was paid in much the same fashion. The check of Star Associates numbered 155, dated April 24, 1978, in the amount of $20,875 and payable to Tom Bednar was used to purchase a cashier's check in the same amount also payable to Tom Bednar. The latter check was used to pay off a lien held by Tom Bednar on property owned by Douglas Stewart at 1809 Harvard Street in Houston. The property was conveyed on September 14, 1976, to Douglas Stewart and on June 2, 1978, Douglas Stewart conveyed the property to his daughter, Susan Stewart Crouse, and to his son, Douglas L. Stewart.

The third set of properties conveyed by Douglas Stewart in undivided halves to his children on June 2, 1978, was located at 1228, 1228-1/2, 1230, 1230-1/2, and 1232-1/2 Nicholson Street in Houston. The check of Star Associates numbered 156, dated April 24, 1978, in the amount of $23,950 and payable to Nicholson Equities was used to buy a cashier's check which in turn was used to buy two new cashier's checks. One of the cashier's checks, in the amount of $5,579.87, was used to pay off the first lien on property purchased by Douglas Stewart on September 2, 1976, at

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1228, 1228-1/2, 1230, 1230-1/2, and 1232-1/2 Nicholson Street in Houston. This property was conveyed to Douglas Stewart's children on June 2, 1978. The remaining cashier's check was used to purchase yet another cashier's check in the amount of $18,370.13.

A portion of the funds paid to Star Associates by Foundation Steel was used to establish personal savings accounts or certificates of deposit for Douglas Stewart, President of Foundation Steel. The check of Star Associates numbered 120, dated September 14, 1976, in the amount of $25,500 was used to purchase a cashier's check payable to D. Stewart. This check was then used to purchase a second cashier's check that was used to open a savings account styled Douglas L. Stewart or D.L. Stewart. The same procedure was followed with an initial check of Star Associates dated November 30, 1976, in the amount of $22,500. The second cashier's check, together with $2,500 in cash, was used to purchase a certificate of deposit dated May 25, 1977, in the name of Douglas L. or D.L. Stewart. Three checks of Star Associates aggregating $58,313.03 were made payable to D. Stewart. The check of Star Associates numbered 145, dated May 25, 1977, in the amount of $12,572.08 payable to Douglas L. Stewart, was deposited into a savings account in the name of Douglas L. or D.L. Stewart.

Other purposes were also served by the Foundation Steel funds paid to Star Associates. The checking account of Star Associates was reduced $30,000 on March 3, 1977, for the purchase

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of a cashier's check payable to L.C. Hartman. This represented a loan from Douglas Stewart to L.C. Hartman. The check of Star Associates numbered 154, dated April 24, 1978, in the amount of $5,562 and payable to D.A. Bowyer represents a payment for child support to the ex-wife of J.D. Hansen, an employee of Foundation Steel.

Four unnumbered checks of Star Associates aggregating $88,599 were used to purchase cashier's checks payable to H.C. or H.R. Chamblee. The four cashier's checks were, in turn, used, along with $1,501 in cash, by Douglas Stewart to purchase a cashier's check dated July 12, 1976, in the amount of $90,000 payable to Guardian Title Company. This check was used by Douglas Stewart to purchase real estate located at 1220 Telephone Road in Houston. The property was then conveyed by Douglas Stewart to South Texas Warehouses, Inc.

Prior to 1977, South Texas Warehouses, Inc., an unrelated corporation, owned the property at which the offices of Foundation Steel are now located. Foundation Steel paid $950 per month to South Texas Warehouses, Inc., as rent on the property prior to 1977. In January 1977, South Texas Warehouses, Inc., conveyed the property to Douglas Stewart. The general journals for Foundation Steel reflect an increase in rent from $950 per month to $3,000 per month beginning January 31, 1977. The rent checks of $3,000 per month continued to be made payable to South Texas Warehouses despite the change in ownership of the property. The rent checks were deposited in bank accounts styled South

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Texas Warehouses, with signature authority in Douglas Stewart, Walter Morris, and Jack Burns. The rental income was not reported by Douglas Stewart on his individual tax return for the taxable years 1977 and 1978. The property was deeded in undivided one-half interests by Douglas Stewart to his son, Douglas L. Stewart, and his daughter, Susan Stewart Crouse, on June 2, 1978.

The checks of Star Associates numbered 143 and 144 dated April 29, 1977, and May 25, 1977, respectively, payable to Metallic Building Co. aggregating $75,604.92 were used to pay for the construction of a building on 350 West 26th Street in Houston, where Foundation Steel is located.

A payment by Foundation Steel dated August 23, 1976, in the amount of $1,750, which was deducted on its income tax return as an insurance expense, included $1,500 for payment of the premium on a fire insurance policy covering property at 1220 Telephone Road in Houston owned by Douglas Stewart. Similarly, in the taxable year 1978, payments aggregating $843 deducted by Foundation Steel on its income tax return as insurance expense represented insurance premiums on property owned by Douglas Stewart. Payments during the taxable year 1978 totaling $9,478.76, deducted by Foundation Steel as utility expenses, represented payments of utility bills on various properties owned by Douglas Stewart.

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On July 29, 1981, the Commissioner issued statutory notices of deficiency to petitioner for the taxable years 1977 and 1978. As relevant to the issues that have not been conceded, the Commissioner determined that Foundation Steel, through the acts of its officers and shareholders, evaded income taxes by omitting substantial amounts of gross receipts, claiming false costs of goods sold, and inflating other deductions. Specifically, Foundation Steel was determined to have overstated its cost of goods sold for the taxable year 1977 and 1978 in the respective amounts of $496,234.84 and $229,228.18. The Commissioner also disallowed a portion of the expenses deducted by Foundation Steel during each of the two taxable years on the grounds that they were, in part, nondeductible personal expenditures and, in part, capital expenditures. Respondent was granted leave to file an amended answer for the taxable year 1978 based upon disallowance of the privilege of petitioner to file a consolidated income tax return with Burns. The amendment resulted in total deficiencies in tax and addition to tax under section 6653(b) of $422,422.08 and $211,211.04, respectively.

OPINION

The Commissioner's determination in his statutory notices of deficiency is presumptively correct as to the underlying deficiency in income tax and petitioner has the burden of disproving each adjustment. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). The burden of proof as to the civil fraud

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addition and on the issue raised by respondent's amended answer is on respondent. The issues for decision are whether Burns and Foundation Steel were entitled to file a consolidated income tax return for the taxable year 1978 and whether petitioner is liable for the addition to tax under section 6653(b) for fraud.

An affiliated group of corporations is authorized to file a consolidated income tax return upon the consent of all members of the affiliated group. Sec. 1501. An affiliated group includes a group in which the parent corporation owns 80 percent of the total voting power of the stock of the subsidiary. Petitioner contends that Foundation Steel owns 80 percent of the voting stock of Burns, and that the two entities were, therefore, entitled to file a consolidated return for the taxable year 1978. None of the stock certificates issued by Burns were issued to Foundation Steel. Fifteen percent of the shares were issued to Douglas L. Stewart. The remainder of the stock was issued in the name of Douglas L. Stewart, Trustee. The trust agreements each list a beneficiary who was an employee of either Foundation Steel or Burns. In no instance is Foundation Steel either a primary or secondary beneficiary of the trust agreement.

Petitioner asks the Court to ignore the express provisions of the trust agreements and to find that Douglas Stewart was acting as a representative of Foundation Steel. This interpretation is not supported by any provision in the trust agreements. Further, in the event of the failure of the trust by virtue of the termination of the employment of the named

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beneficiary, the stock was transferable to Douglas L. Stewart and not to either Foundation Steel or to Douglas L. Stewart as President of Foundation Steel. We find that Douglas L. Stewart, individually, and as trustee, was owner of 100 percent of the stock of Burns. Eighty percent of Foundation Steel was also owned by Douglas L. Stewart. Common ownership of brother-sister corporations does not, however, qualify Foundation Steel and Burns to file consolidated income tax returns. Ray Engineering Co., Inc. v. Commissioner, 42 T.C. 1120, 1122 (1964), affd. 347 F.2d 716 (3d Cir. 1965). Respondent is sustained upon this issue. Sec. 1504.

The remaining issue for decision is whether petitioner is liable for the additions to tax under section 6653(b) for fraud. As noted the burden of proving fraud is on respondent and he must do so by clear and convincing evidence. Sec. 7454(a); Rule 142(b); Levinson v. United States, 496 F.2d 651 (3d Cir. 1974); Stone v. Commissioner, 56 T.C. 213, 220 (1971). This burden is met if it is shown that the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes, and that there is an underpayment of tax. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968), cert. denied 393 U.S. 1020 (1969); Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983); Acker v. Commissioner, 26 T.C. 107, 112 (1956).

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When fraud is asserted, as in the instant case, for more than one taxable year, respondent must show that some part of the underpayment was due to fraud for each taxable year for the corresponding addition to tax to be upheld. Professional Services v. Commissioner, 79 T.C. 888, 930 (1982); Nicholas v. Commissioner, 70 T.C. 1057, 1065 (1978); Otsuki v. Commissioner, 53 T.C. 96, 105 (1969). The existence of fraud is a question of fact to be resolved upon consideration of the entire record. Rowlee v. Commissioner, supra at 1123; Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Fraud will never be presumed. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). Fraud may, however, be proved by circumstantial evidence because direct proof of the taxpayer's intent is rarely available. Stephenson v. Commissioner, 79 T.C. 995, 1005-1006 (1982), affd. 748 F.2d 331 (6th Cir. 1984); Gajewski v. Commissioner, supra at 200. The taxpayer's entire course of conduct may establish the requisite fraudulent intent. Spies v. United States, 317 U.S. 492 (1943); Gajewski v. Commissioner, supra at 200. The proof may also rest upon reasonable inferences properly drawn from the evidence on record. Stone v. Commissioner, supra at 223-224.

Any conduct, the likely effect of which would be to mislead or conceal, is indicative of fraud. Spies v. United States, supra at 499. The failure to keep adequate books and records indicates an attempt to defraud. Agnellino v. Commissioner, 302 F.2d 797, 801 (3d Cir. 1962); Papineau v. Commissioner, 28 T.C.

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54, 58 (1957). The consistent understatement of substantial amounts of income over several years is strong evidence of fraud. Merritt v. Commissioner, 301 F.2d 484, 487 (5th Cir. 1962); Shahadi v. Commissioner, 266 F.2d 495, 501 (3d Cir. 1959), affg. 29 T.C. 1157 (1958). It is well settled that a fraudulent understatement of income can also be accomplished by means of an overstatement of deductions. Hicks Co. v. Commissioner, 56 T.C. 982, 1019 (1971), affd. 470 F.2d 87 (1st Cir. 1972); Neaderland v. Commissioner, 52 T.C. 532, 540 (1969), affd. 424 F.2d 639 (2d Cir. 1970).

Respondent has affirmatively shown numerous indicia of fraud. Numerous checks were cashed rather than deposited to the Foundation Steel bank accounts in both of the taxable years at issue. Taxable income was also diverted from petitioner by an overstatement of expenses caused by fraudulent payments to Star Associates in both of the taxable years at issue. The expenses shown on the returns of petitioner for the taxable years 1977 and 1978 also included excessive rentals nominally paid to a third party but, in fact, paid to shareholders of Foundation Steel. The President of Foundation Steel, Douglas Stewart, used these sums to support a female friend and her child, to buy property for his children, to pay his obligations to his ex-wife, and to pay for items of personal benefit to him. A variety of bank accounts and the purchase of multiple layers of cashier's checks were used to accomplish these purposes, primarily by the diversion of funds through Star Associates, a fictitious entity.

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Foundation Steel itself also made direct payments for Douglas Stewart's benefit in the form of utility and insurance payments and in the form of payments to Debra Kuehn despite the fact that she did no work whatsoever for Foundation Steel. These acts by petitioner were purposeful and were committed with intent to evade tax by the understatement of income, and overstatement of expenses. Further, petitioner's accountant was not informed of the existence of the additional accounts nor of the illusory quality of many of the payments reflected on the books of Foundation Steel.

We are the trier of fact. It is our duty to listen to the testimony, observe the demeanor of the witnesses, weigh the evidence, and determine what we will or will not believe. We are not required to accept testimony at face value, and we may discount a witness' self-interested testimony and place our reliance on other testimony which we believe is more reliable. Archer v. Commissioner, 227 F.2d 270 (5th Cir. 1955); Weiss v. Commissioner, 221 F.2d 153 (8th Cir. 1955). In this case, Douglas Stewart in many cases admitted the fraudulent conduct shown by the record. He was simply not credible in the few instances in which he claimed to have a lack of control over Star Associates or a lack of knowledge as to the purposes of various payments. In essence, petitioner's own witness confirmed the abundant and unrefuted evidence of fraudulent actions taken by

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Foundation Steel. Under these circumstances, we have no difficulty whatsoever sustaining the determination of the Commissioner as to the additions to tax for fraud.

As both parties have made concessions,

Decisions will be entered under Rule 155.

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T. C. Memo. 1986-430

UNITED STATES TAX COURT

WILFORD F. BURRHUS AND SALLY A. BURRHUS, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13244-83. Filed September 11, 1986.

Wilford F. Burrhus, pro se.

Patricia Y. Taylor, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined deficiencies in and additions to petitioners' income tax as follows:

Year	Deficiency	Addition to Tax Section 6653(a)[1]
1979	$ 3,246.00	$ 162.30
1980	3,293.00	164.65

[1] All section references are to the Internal Revenue Code of 1954, as amended, during the years in issue unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

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After concessions, the issues for decision are: (1) whether petitioners are entitled to certain deductions for employee business expenses; (2) whether certain activities by petitioners constituted activities "not engaged in for profit" under section 183; (3) whether petitioners are entitled to deduct seminar and travel expenses in excess of those allowed by respondent; and (4) whether the deficiencies due from petitioners are attributable to negligence or the intentional disregard of rules and regulations within the meaning of section 6653(a).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation and exhibits attached thereto are incorporated herein by reference.

Petitioners, Wilford F. Burrhus and Sally A. Burrhus, husband and wife, resided in DeSoto, Texas, at the time they filed their petition. During 1979 and 1980, Wilford was employed in Jacksonville, Florida by Sears as the manager of a Data Processing Center . He received wages of $36,018 and $38,418, respectively. Sally was a housewife during this period.

(1) Employee Business Expenses

As the manager of the Data Processing Center, Wilford had sole responsibility for its operations. Sears evaluated his job performance in part by the morale of his staff members. To maintain good morale and a sense of camaraderie, petitioner

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frequently treated his staff to coffee, lunches, dinners, and fishing trips. The only expenditure of this nature for which he ever sought and received reimbursement from Sears was $475 spent in 1979 on a farewell dinner for one of the employees. On their returns for 1979 and 1980, petitioners claimed deductions for nonreimbursed employee business expenses totaling $3,490.00 and $4,485.70, respectively.

(2) Activities to Which Section 183 is Applicable

Writing Activities

In 1978, Wilford began to write short stories after coming to the conclusion that he had a "gift for telling a story." The only advice and instruction on writing which Wilford sought or received was from one of his employees, Robert Wilkie, who permitted Wilford to use certain materials received in a correspondence course. Although Wilkie had not finished the course or succeeded in publishing anything, he gave Wilford advice and edited his writings.

Wilford completed several short stories but was unable to sell any of them. Consequently, he received no income from his writing activities and ceased them entirely in 1983.

On their returns for 1978, 1979, and 1980 petitioners claimed deductions totaling $2,022.63, $5,704.99 and $4,418.82, respectively, for expenditures made with respect to the writing

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activities.[2] The deductions claimed for 1979 and 1980 were as follows:

	1979	1980
Truck Expenses	$1,997.73	$1,501.42
Depreciation	1,758.51	1,758.51
Postage	---	12.70
Rent on business property	459.88	---
Repairs	---	479.20
Supplies	1,410.82	293.88
Travel and Entertainment	---	373.11
Tolls	78.00	---
Total Deductions	$5,704.99	$4,418.82

Shaklee Activities

In 1976, petitioners had become distributors for Shaklee, a manufacturer of organic food supplements and cleaning compounds. They reported losses of $5,493.17 and $2,845.05 on gross incomes of $16.59 and $32.53 in 1977 and 1978, respectively.[3]

On their returns for 1979 and 1980, petitioners claimed deductions with respect to their Shaklee activities of $42.71 and $1,964.38 while reporting gross receipts of $5.26 and $16.75. The deductions claimed were as follows:

	1979	1980
Car and truck expenses	$ 16.84	$ 28.00
Furniture depreciation	25.87	25.87
Travel and Entertainment	--	1,910.51
Total Deductions	$ 42.71	$1,964.38

2 Petitioners' return for 1978 was not audited; hence, the $2,022.63 loss was allowed.

3 The returns for 1977 and 1978 were not audited.

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The deduction of $1,910.51 for travel and entertainment expenses resulted from a trip taken by petitioners' entire family to Michigan. At trial petitioners conceded that at least $799.42 of the $1,910.51 is attributable to nondeductible personal items.

Coin and Antique Gun Activities

In 1980, Wilford purchased coins and antique guns for approximately $6,200. He also spent $242.17 for information books, coin containers, and similar supplies. Petitioners reported no income from these activities, but claimed deductions for the supplies, plus another $155.95 for car and truck expense and depreciation.

(3) Seminar and Travel Expenses

In addition to being a housewife, Sally is a painter. She usually sells her paintings at arts and crafts shows. However, in 1979, petitioners paid the expenses her parents incurred on a trip from Michigan to Florida and back. While in Florida the parents stayed at petitioners' home and inspected Sally's artwork. On their return to Michigan they took several pieces of her work with them in the hope of selling it for Sally. When only a few pieces sold, the parents became discouraged and discontinued their efforts.

On their 1979 return, petitioners claimed a deduction for travel expenses totaling $939.76 which included $402 for the round trip air fares of her parents and $424.39 for meals during

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their Florida visit. Petitioners also claimed a deduction for seminars and training in the amount of $386.53. The record contains no evidence with respect to this item.

OPINION

(1) Employee Business Expenses

Petitioners contend that with respect to Wilford's employment at Sears they are entitled to deductions totaling $3,490.00 in 1979 and $4,485.70 in 1980 for amounts expended on behalf of Sears' employees. Respondent contends the deductions are not allowable because petitioners have failed to establish that any amount was expended for the purpose claimed, that any expenditure made was an ordinary and necessary business expense, and that any such expenditure was not subject to reimbursement by Sears. Petitioners have the burden of proof. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

From the record as a whole, we are convinced that Wilford expended certain funds in behalf of the members of his staff. However, we are unable to determine from the record the nature and amount of the expenditures which were ordinary and necessary to his job and which were not. We are also unable to determine which were reimbursable by Sears. While petitioners have placed in the record various bits of evidence such as calendars and credit card receipts, they have utterly failed to demonstrate the

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relevance of these exhibits to their claimed expenses. Consequently, they have failed to carry their burden of proof and respondent's disallowance of the deductions is sustained.

(2) Section 183 Activities

In his notice of deficiency respondent determined that all of the deductions claimed by petitioners with respect to their writing, Shaklee, and coin and gun activities should be disallowed because such activities were not engaged in for profit within the meaning of section 183.

Section 183(a) provides that if an activity is not engaged in for profit, no deduction attributable to such activity is allowable except as provided in section 183(b). Section 183(b) separates deductions claimed with respect to an activity not engaged in for profit into two categories, i.e., those which are not dependent upon a profit motive and those which are so dependent. Then under section 183(b)(1) the deductions which are not dependent upon a profit motive such as taxes and interest are allowable in full but under section 183(b)(2) the deductions which are dependent upon a profit motive are deductible only to the extent that the gross income derived from the activity exceeds the deductions allowable under section 183(b)(1).

Insofar as applicable here, an "activity not engaged in for profit" is defined in section 183(c) as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162." Section 162 allows as a

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deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. In order to constitute a trade or business under section 162 an activity must "be entered into, in good faith, with the dominant hope and intent of realizing a profit, i.e., taxable income, therefrom." Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963), affg. a Memorandum Opinion of this Court. See also Hager v. Commissioner, 76 T.C. 759, 784 (1981), and cases cited therein.

The expectation of a profit need not be a reasonable one. It is sufficient if there is a bona fide objective of making a profit. Fox v. Commissioner, 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1141 (2d Cir. 1984), affd. sub nom. Barnard v. Commissioner, 731 F.2d 230 (4th Cir. 1984), affd. without published opinion sub nom. Hook v. Commissioner, Kratsa v. Commissioner, Leffel v. Commissioner, Rosenblatt v. Commissioner, Zemel v. Commissioner, 734 F.2d 5-7, 9 (3d Cir. 1984); Hager v. Commissioner, supra. Whether there is an intention to make a profit is one of the facts to be resolved from all the surrounding circumstances. Golanty v. Commissioner, 72 T.C. 411, 426 (1979), affd. in an unpublished opinion 647 F.2d 170 (9th Cir. 1981); Dunn v. Commissioner, 70 T.C. 715, 720 (1978), affd. 615 F.2d 578 (2d Cir. 1980).

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The burden of proof with respect to the requisite intention is on petitioners. Rule 142(a); Golanty v. Commissioner, supra at 426. In making the determination as to intent, objective facts are to be given greater weight than the parties' statements of their intent. Fox v. Commissioner, supra at 1007.

Section 1.183-2(b), Income Tax Regs., contains a nonexclusive list of factors which have been considered relevant to a determination of whether an activity was engaged in for profit. Golanty v. Commissioner, supra. These factors are as follows: (1) the manner in which the taxpayer carries on the activity, (2) the expertise of the taxpayer or his advisors, (3) the time and effort expended in carrying on the activity, (4) the expectation that assets used in the activity might appreciate in value, (5) the success of the activity and of the taxpayer in carrying on other similar or dissimilar activities, (6) the taxpayer's history of income or losses with respect to the activity, (7) the amount of profits, if any, which were earned, (8) the financial status of the taxpayer, and (9) elements of personal pleasure or recreation.

First, petitioners failed to keep proper records with respect to all of such activities. Secondly, the activities were obviously not conducted in a businesslike manner. Thirdly, Wilford admittedly had no previous experience with writing or in dealing with coins and guns. Nevertheless, he made no reasonable attempt to acquire competent help or advice with respect to either activity. He did receive advice and instruction from

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Robert Wilkie about writing, but Mr. Wilkie had not even completed a correspondence course in the subject and had never succeeded in publishing anything. Furthermore, the record contains no evidence of any attempt by petitioners to obtain advice or assistance with respect to either the Shaklee activities or with respect to the coins and guns. Fourthly, none of the activities were ever profitable. In fact, two of them never produced any receipts and the third, the Shaklee activities, only generated about $70.00 in gross receipts in four years, while suffering over $10,000 in losses.

Finally, from our observations at trial, it was apparent that Wilford derived a great deal of personal pleasure from the writing and the coin and gun activities. We are convinced, therefore, that these activities were strictly hobbies and from a close examination of the scant record before us, we are satisfied and so find that the writing, Shaklee and coin and gun activities were not engaged in by petitioners with the requisite profit objective. However, in the absence of any expenditures for interest and taxes, the deductions claimed with respect to the Shaklee activities are allowable under section 183(b)(1) to the extent of $5.26 in 1979 and $16.75 in 1980.

(3) Seminar and Travel Expenses

In connection with Sally's painting activities petitioners claimed deductions for travel expenses of $939.76 in 1979 and $298.43 in 1980. They also claimed seminar expenses of $386.53

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and $381.21, respectively. Respondent allowed both the travel and seminar expenses for 1980, but with respect to 1979 respondent disallowed travel expenses in excess of $347.40 and seminar expenses in excess of $152.50 for lack of substantiation.

Here again petitioners have the burden of proof. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

The record contains no proof with regard to seminar expenses for 1979 and this item is deemed to have been conceded by petitioners. As to the travel expenditures, the disallowed portion is attributable entirely to the sums expended on the trip to Florida by Sally's parents. While they did examine some of her work while in Florida and actually took some of it back to Michigan for sale, we are convinced from the record as a whole that the purpose of the trip was predominantly personal and not business and therefore respondent's determination on this issue is sustained.

(4) Negligence

Respondent's determination that petitioners are liable under section 6653(a) for the addition to tax for negligence or the intentional disregard of rules and regulations is presumptively correct and petitioners have the burden of proving the determination is erroneous. Welch v. Helvering, supra; Otis v. Commissioner, 73 T.C. 671 (1980); Rule 142(a).

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Since petitioners have offered no proof on this issue, respondent's determination is sustained.

Decision will be entered under Rule 155.

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T. C. Memo. 1986-431

UNITED STATES TAX COURT

ESTATE OF JAMES A. YEOHAM, DECEASED, AND VELMA YEOHAM, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17286-83. Filed September 11, 1986.

Leon Crum, for the petitioners.

Linda L. Wong, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined deficiencies in and additions to petitioners' Federal income taxes as follows:

Year	Deficiency	Additions to Tax Section 6653(a) [1]
1979	$ 134,320.00	$ 6,716.01
1980	128,941.96	6,447.10
1981	19,475.94	973.80

[1] All section references are to the Internal Revenue Code of 1954, as amended during the years in issue, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

C.M /ll

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After concessions, the issues remaining for decision are: (1) whether certain "trust organizations" are recognizable for Federal income tax purposes; (2) if they are so recognizable, whether petitioners are taxable on the income of the organizations under the grantor trust provisions of sections 671 through 679; (3) whether petitioners are liable for additions to tax under section 6653(a); and (4) whether petitioners are liable for damages under section 6673.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation and exhibits associated therewith are incorporated herein by reference.

Petitioners are Velma Yeoham and the estate of her deceased husband, Dr. James Yeoham. In 1979 and 1980, Dr. and Mrs. Yeoham resided in Irving, Texas and filed joint income tax returns. During 1981 Dr. Yeoham died and for 1981, a joint income tax return was filed for Dr. Yeoham, deceased, and Mrs. Yeoham, who resided in Irving, Texas, at the time the petition was filed.

During the years at issue and for several years prior thereto, Dr. Yeoham was engaged in the practice of surgery. In 1977, he had become a member of the American Law Association ("ALA") after attending an introductory membership program at which he was provided a package of pre-printed forms for establishing "trust organizations." After receiving the forms, Dr. Yeoham traveled with his wife in July, 1977 to one of the

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islands in the British West Indies. While on the island, they used the forms purportedly to create three trusts, i.e., Candu Trust Organization ("Candu"), Willdu Trust Organization ("Willdu"), and Maydu Trust Organization ("Maydu"). The instruments purportedly creating these organizations were signed by one or both of the Yeohams as "exchangors," and by Lloyd Roberts, a resident of the island, as "creator." After returning to Texas, the Yeohams, in November 1977, purportedly created another trust in Texas known as PACA Properties ("PACA"). The Yeohams individually and Dr. Yeoham's professional corporation were the exchangors of PACA, and John Drew was its creator.

The trust documents recited that the Yeohams and their children owned all 100 "trust certificate units" in Candu, Candu owned all 100 trust certificate units in Willdu, Willdu owned all 100 trust certificate units in Maydu, and Maydu owned all 100 trust certificate units in PACA. According to the documents, the Yeohams and Dr. Yeoham's professional corporation transferred to Maydu all of the equipment and supplies theretofore used by Dr. Yeoham in his medical practice as well as a piece of real property located in Missouri. The Yeohams also transferred three automobiles to PACA.

In the trust documents the Yeohams were designated trustees for Candu; Candu was designated trustee for Willdu; and Willdu was designated trustee for Maydu and PACA. Each of the preprinted instruments that purportedly established the trust organizations provided:

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> The named Trustee(s), for themselves and their successors in trust irrevocable do hereby accept the conveyance and acknowledge delivery of all the property specified, together with all the terms of the Trust Organization herein set forth, agreeing to conserve and improve the Trust Organization, to invest and reinvest the funds of said Trust Organization, in such manner as will increase the financial rating of the Trust Organization exercising their best judgment and discretion, in accordance with the Trust minutes, making distribution of portions of the proceeds and income as in their discretion, and according to the minutes, and upon the final liquidation distributing the assets to the existing certificate holders as their contingent rights may appear; and in all other respects administering said Trust Organization in good faith, strictly in conformity hereto.

The designated trustees of each trust could be removed only by a unanimous resolution of the board of trustees or by a court and the trustees were empowered to appoint a successor for any trustee who died or was removed for any reason.

Under the trust documents, the trustees were provided with extremely broad powers with provisions such as the following:

> Trustees' powers shall be construed as general common-law powers of citizens of the Colony of Turks and Caicos (Islands)[2] to do anything any citizen may due in any state or country. They shall, but not be limited to, continue in business, conserve the property, commercialize the resources, extend any established line of business in industry or investment, as herein specially noted, at their discretion for the benefit of this Trust Organization such as, viz: buy, sell or lease land for surface or mineral rights; buy or sell mortgages, securities, bonds, notes, leases of all kinds, contracts or credits of any form, patents, trademarks or copyrights; buy, sell, or conduct mail-order business, or branches thereof; operate stores, shops, factories, warehouses, or other trading establishments or places of business of any kind; allocate funds derived from any source for charity, religion, education, research, accumulating, or other purposes, whether for immediate or future application

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2 The PACA documents referred to "citizens of the United States."

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to be managed by specified Trustee, Trustees, or others as designated by the Trustee's minutes; construct, buy-sell, or lease or rent any type of real estate, improved or unimproved; advertise different articles or business projects; borrow money for any project, pledging the Trust Organization property for the payment thereof; hypothecate assets, property, or both; own stock in, or entire charters of corporations, or other properties, companies or associations as they may deem advantageous.

Resolutions of the Board of Trustees authorizing a special thing to be done shall be evidence that such act is within its power. Anyone lending or paying money to the Board of Trustees shall not be obliged to see the application thereof. All funds paid into the treasury are and become a part of the corpus of the Trust Organization.

With regard to the duration and termination of the trusts, each instrument provided:

This Trust Organization shall continue for a period of twenty-five years from date, unless the Trustees shall unanimously determine upon an earlier date. The Trustees may at their discretion, because of threatened depreciation in values, or other good and sufficient reason, liquidate the assets, distribute and close the Trust Organization at any earlier date determined by them. The Trust shall be proportionately and in a pro rata manner distributed to the Certificate Holders.

The rights of the holder of a trust certificate in each of the trust organizations were defined as follows:

Ownership of certificate shall not entitle the holder to any legal title or equitable title in or to the Trust Organization property, nor any undivided interest therein, nor in the management thereof, nor shall the death of a holder entitle his heirs or legal representatives to demand any partition or division of the property of the Trust Organization, nor any special accounting. The rights of the certificate holders in personam are limited merely to a claim against the trustees to carry out this Declaration of Trust.

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In December 1977, Dr. Yeoham, in his individual capacity, and Mrs. Yeoham, as an agent for PACA, executed a contract under which PACA agreed to lease an automobile to Dr. Yeoham. The automobile was one of the three originally transferred by the Yeohams to PACA.

Dr. Yeoham, in his individual capacity, and Mrs. Yeoham, as a trustee for Maydu, executed in August 1978 a "contract for services" in which Maydu agreed to provide to Dr. Yeoham the following: (1) office furniture and equipment; (2) medical supplies; (3) "research and consultation;" (4) maintenance of rental equipment; (5) office space; (6) legal and accounting fees; and (7) management services. The personal property leased by Maydu to Dr. Yeoham initially was the same property Dr. Yeoham had transferred to Maydu in 1977, and the office space was the same space of which Dr. Yeoham had been lessee prior to the creation of Maydu. The management and maintenance services were performed by Mrs. Yeoham, who was Maydu's sole employee. The "research and consultation" services included a subscription to the Wall Street Journal and a seminar on investing money.

Until he became ill, Dr. Yeoham was Maydu's only source of income except rental income from the Missouri property. During the years 1979 through 1981, Dr. Yeoham made payments to Maydu for purported services and to PACA for purported car rentals totaling $364,626. All of the payments were deducted as business expenses on the Yeoham's joint returns for 1979, 1980 and 1981.

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OPINION

Respondent first contends that the trust organizations are not entitled to be recognized for income tax purposes. On their part, petitioners contend that the organizations are valid common law business trust organizations which were set up for legitimate business purposes, including the reduction of premiums on Dr. Yeoham's malpractice insurance.

The "sham" contention as asserted in this case requires that we not only examine the organizational documents and surface transactions of the entities involved, but it also requires that we examine their economic realities. Weyl-Zuckerman & Co. v. Commissioner, 23 T.C. 841, 847 (1955), affd. per curiam 232 F.2d 214 (9th Cir. 1956). In other words, we must look beyond the "superficial formalities of a transaction to determine the proper tax treatment." Blueberry Land Co. v. Commissioner, 361 F.2d 93, 101 (5th Cir. 1966), affg. 42 T.C. 1137 (1964). Labels, semantic technicalities, and formal documents do not necessarily control the tax consequences of a given transaction. Instead, we must be concerned with economic realities and not the form employed by the parties. Frank Lyon Co. v. United States, 435 U.S. 561, 572 (1978). Moreover, transactions which are devoid of economic substance and are engaged in solely to acquire tax benefits should be disregarded, Knetsch v. United States, 364 U.S. 361 (1960); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981); Derr v. Commissioner, 77 T.C. 708 (1981), and the determination of whether the transactions and entities lack

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economic substance is a factual question that must be decided within the unique parameters of this case. United States v. Cumberland Public Service Co., 338 U.S. 451 (1950). Additionally, the fact that all of the entities involved herein were controlled, either directly or indirectly, by the Yeohams requires that we closely scrutinize all transactions in order to determine their substance. Investors Diversified Services, Inc. v. Commissioner, 39 T.C. 294, 306 (1962), affd. 325 F.2d 341 (8th Cir. 1963); Bixby v. Commissioner, 58 T.C. 757, 776 (1972).

In prior cases, we have applied the above principles to trust organizations which were almost identical to those in this case. See Zmuda v. Commissioner, 79 T.C. 714 (1982), affd. 731 F.2d 1417 (9th Cir. 1984); Professional Services v. Commissioner, 79 T.C. 888 (1982). In both Zmuda and Professional Services we concluded that the trust organizations were paper entities structured solely to avoid taxes and therefore not recognizable for income tax purposes because the creation and use of the trust organizations did not alter in any way the taxpayers' economic relationship to the properties transferred to the trusts by the taxpayers. The terms and conditions of the documents purportedly creating the organizations left the taxpayers in exactly the same relationship to the properties after the "transfers" that they were in prior to such transfers.

In the case before us, the Yeohams were the trustees of Candu, which was the trustee of Willdu, which was the trustee of Maydu and PACA. Thus, in effect, the Yeohams were the trustees

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of each trust organization and, as such, had unrestricted authority to act in any manner with respect to the property owned by all of the organizations. Furthermore, the Yeohams and their children owned, directly or indirectly, all of the certificates in all of the trusts which entitled them to all of the organizations' assets upon their termination.

Moreover, the purported transfers did not create any proprietary rights in anyone other than the Yeohams. Although the trust organizations were allegedly "created" by third parties, these parties were nominees only and neither had nor acquired any power over or rights in the assets.

For the reasons set forth above, we agree with respondent that the trust organizations lacked any economic substance and were formed solely to generate tax deductions. Therefore, they and the transactions with them cannot be recognized for income tax purposes.[3]

Additions to Tax Under Section 6653(a)

Respondent's determination that petitioners are liable for the addition to tax for negligence under section 6653(a) is presumptively correct and the burden of proving that the determination is erroneous is upon petitioners. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

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[3] Because we find that the trust organizations are to be treated as nullities, it is unnecessary to address respondent's argument concerning the grantor trust rules.

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In view of the complicated and suspect nature of the trust organizations as well as the large amount of money involved, we believe that a reasonable and prudent person would have made serious and prolonged inquiries into the validity, tax and otherwise, of the program used by petitioners. However, the record before us contains no evidence which tends to establish that petitioners made such inquiries. We conclude therefore that respondent's determination with respect to the addition to tax is correct.

Damages Under Section 6673

Finally, we turn to respondent's request that damages be imposed against petitioners under section 6673 for having instituted or maintained a proceeding primarily for delay or to present a position that is groundless and frivolous.

Petitioners instituted and continued to maintain their position herein after our decisions in Zmuda v. Commissioner, supra, and Professional Services v. Commissioner, supra, had clearly established that trust organizations like those in this case are shams and are not recognizable for income tax purposes. It is apparent, therefore, that petitioners instituted and maintained this proceeding primarily for delay. Consequently, damages in the amount of $5,000 are awarded to the United States under section 6673. See Sydnes v. Commissioner, 74 T.C. 864, 872 (1980).

Decision will be entered for respondent.

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T. C. Memo. 1986-432

UNITED STATES TAX COURT

GERARD R. HILLS, ET AL.,[1] Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 20526-84, 20577-84, 20578-84.

Filed September 11, 1986.

Michael H. Singer, for the petitioners.

Kenneth A. Burns, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined deficiencies in and additions to petitioners' income taxes for 1980 as follows:

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[1] Cases of the following petitioners are consolidated herewith: William L. and Rita Shields, docket No. 20577-84; and Douglas B. and Karen Brewer, docket No. 20578-84.

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Petitioner	Deficiency	Additions to Tax Section 6653(a)[2]	Section 6651(a)
Hills	$ 6,331.43	$ 316.57	$ -0-
Shields	6,303.00	315.15	1,281.31
Brewer	8,227.30	411.37	-0-

After concessions, the only issue remaining for decision is whether petitioners are relieved from their 1980 income tax liabilities because of the so-called toke compliance program initiated by respondent.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation and exhibits attached thereto are incorporated herein by reference.

All petitioners resided in Las Vegas, Nevada at the time their petitions were filed in these cases. During 1980, petitioners Gerard R. Hills (Hills), William L. Shields (Shields), no relationship to the author of this opinion, and Douglas B. Brewer (Brewer), were employed as twenty-one dealers at different casinos in Las Vegas. They each received a salary and were entitled to keep tokes, which are casino chips given by a patron to a dealer as tips or placed as bets for him. Each petitioner admits that all of his toke income for 1980 was not reported on a timely filed 1980 return.

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[2] All section references are to the Internal Revenue Code of 1954, as amended, during the years in issue unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

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In 1981, the Nevada District of the Internal Revenue Service initiated a toke compliance program designed to increase compliance by casino dealers in the reporting of their toke income. Participating dealers agreed to keep a daily record of their toke income, submit the daily record to the Internal Revenue Service on a monthly basis, and report monthly to their employers all toke income received. Each participating dealer was to begin complying with the program as soon as he signed up in 1982. The Internal Revenue Service agreed that the toke income of dealers who fully complied would not be audited for years prior to 1982.

Respondent's agents began the program by meeting with the dealers at each casino in late 1981 and early 1982. During these meetings the program was described and the dealers were invited to participate as a group or individually. Individual dealers who wanted to participate could do so by sending a letter to or calling respondent. All of the dealers at each casino, however, had to sign up by a given date which varied from casino to casino. For instance, dealers working at one casino had a deadline of April 15, 1982, while dealers at another casino had until June 15, 1982.

Of the three petitioners, only Shields agreed to participate in the program. However, during 1982, Shields only reported approximately thirty-five percent of his toke income to his employer. Consequently, on April 12, 1983, respondent sent him a "last chance" letter. This was a letter sent to dealers who had

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originally signed up for the program but who had apparently failed to comply with the reporting requirements. In the letter Shields was advised that to be considered in compliance, he would have to send to the District Director by April 15, 1983 a copy of his 1982 return reflecting all of his toke income. The letter advised Shields that if he had already filed a 1982 return which did not include all of his toke income, he could still be in compliance with the program if by April 22, 1983 he filed an amended return containing all of his toke income. Shields filed an original 1982 return containing all of his toke income in November 1983.

Neither Hills nor Brewer reported all of their toke income to their employers during 1982. Hills did not report all of his toke income on his 1982 tax return, but Brewer reported all of his toke income for 1982 on his return for that year.

OPINION

Petitioners contend that they have no income tax liability for 1980 because (1) they met all of the requirements of the toke compliance program; and (2) respondent is estopped from auditing their 1980 returns.

(1) Compliance Program

It is clear from the record as a whole that none of petitioners complied with the program. Shields originally agreed to participate, but forfeited his right to the program's benefits by

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failing to include all of his toke income in his reports to his employer or in a timely filed income tax return. Brewer did not sign up for the program, but claims that he was in compliance because he reported all of his 1982 toke income on a timely 1982 return and reported all of his 1983 toke income to his employer. He, however, failed to report his toke income during 1982 to his employer as required by the program. Hills did not make reports to his employer or include all of his toke income in a timely 1982 return as required by the program. Consequently, they, too, have forfeited the benefits of the program.

(2) Estoppel

The thrust of petitioners' second argument is that respondent is estopped from auditing their returns for 1980 because respondent did not audit the returns of other dealers who were similarly situated. In this connection, we first note that the record as a whole indicates only that respondent did not audit some dealers who had initially signed up for the program but who later failed to fully comply. Consequently, dealers such as Brewer and Hills, who did not sign up, have no basis in the record for their argument that they were treated unfairly.

With respect to Shields, it is conceivable that he may have complied with the program to the same extent as some dealers who were not audited. We, however, cannot go behind a notice of deficiency in order to examine the motives or policies of respondent in making administrative decisions such as whom to

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audit, Proesel v. Commissioner, 73 T.C. 600, 605 (1979); Greenberg's Express, Inc. v. Commissioner, 62 T.C. 324, 327 (1974); Human Engineering Institute v. Commissioner, 61 T.C. 61, 66 (1973), unless there is substantial evidence of unconstitutional conduct on respondent's part. See Greenberg's Express v. Commissioner, supra at 328. No such evidence appears in this record.

Petitioners rely on International Business Machines Corp. v. United States, 343 F.2d 914 (Ct. Cl. 1965) and Tonkonogy v. United States, 417 F. Supp. 78 (S.D. N.Y. 1976). However, those cases do not support petitioners' position. The Court of Claims in International Business Machines Corp. held that two competing businesses which requested identical letter rulings from respondent had to be treated equally. The District Court in Tonkonogy merely held that respondent was bound by the representations of its agents.

We conclude, therefore, that on the record before us there is no basis for relieving petitioners from their 1980 tax liabilities.

Decisions will be entered under Rule 155.

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T. C. Memo 1986-433

UNITED STATES TAX COURT

DALE B. DUBIN and SUSAN J. DUBIN, Petitioners,
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 23140-83. Filed September 11, 1986.

Ralph A. Muoio, Scott D. Michel, Mark T. Tate, and E. Jackson Boggs, for the petitioners.

James F. Kearney and Sara M. Coe, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SWIFT, Judge: In a statutory notice of deficiency dated June 30, 1983, respondent determined deficiencies in petitioners' Federal income tax liabilities, as follows:

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Years	Deficiencies
1978	$ 97,324
1979	146,069
1980	142,170

The primary issue for decision is the fair market value of a jade desk set and certain gemstones and minerals donated by petitioners to the Smithsonian Institution. By amendment to his answer, respondent also asserts the increased rate of interest on substantial underpayments of tax attributable to tax motivated transactions pursuant to section 6621(d).[1]

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. Petitioners were husband and wife during the years in issue but are now divorced. At the time the petition herein was filed, petitioners resided in the State of Florida. Hereinafter, references to petitioner will be to Dale B. Dubin.

Petitioner is a plastic and reconstructive surgeon. He also has been collecting gems and minerals as a hobby for over 25 years. Petitioner has built an extensive gem and mineral collection, and he displays many of his specimens in his medical office.

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[1] All section references are to the Internal Revenue Code of 1954, as in effect during the years in issue.

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In 1972, petitioner purchased for $750 a large colorless topaz crystal weighing approximately 19 pounds (30,225 carats), which he placed in his personal collection. In its natural form, topaz generally is a transparent, colorless gem. In 1974, however, petitioner learned of a new, experimental treatment process involving the combined use of radiation and heat which could produce an artificial blue color in certain topaz crystals. The appearance of a colorless topaz crystal that is successfully treated by this process is similar to natural blue topaz and therefore such a topaz crystal is more valuable than a colorless topaz crystal.

In 1975, petitioner's topaz crystal was partially treated with radiation, which caused it to turn a deep brown color and which also caused some undesirable "cloudiness" in the crystal. Petitioner was informed that the crystal might turn blue if treated further with heat, but he did not subject the crystal to any further treatment.

During the early months of 1977, Paul E. DeSautels ("DeSautels"), at that time curator of the Minerals Department at the Smithsonian Institution ("Smithsonian"), visited petitioner in his home and viewed portions of his gem and mineral collection. DeSautels was soliciting donations of gemstone and mineral specimens to the Smithsonian to increase its gemstone and mineral collections. DeSautels expressed an interest in acquiring from petitioner his large topaz crystal and certain of his other gemstone and mineral specimens.

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DeSautels also informed petitioner of an 18-piece Russian jade desk set which was then on loan to the Smithsonian by its owner, a gemstone dealer named Richard Swaebe ("Swaebe"). Swaebe had purchased the jade desk set in 1975 for about $40,000. DeSautels suggested that petitioner purchase the desk set from Swaebe and simultaneously donate it to the Smithsonian. Acting on DeSautels' suggestion, on March 2, 1977, petitioner purchased the jade desk set for $55,000. In conjunction with the purchase of the jade desk set from Swaebe, petitioner obtained an appraisal of the desk set reflecting a value therefor of $225,000. From March 2, 1977, until December 23, 1977, the desk set remained at the Smithsonian, and on December 23, 1977, petitioner donated the jade desk set to the Smithsonian.

Also on December 23, 1977, petitioner donated to the Smithsonian eight gem and mineral specimens from his collection. Petitioner obtained appraisals of each of the eight specimens prior to the donation thereof. The appraisals reflected the dimensions or weight and value of the specimens, as follows:

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Name of Specimen	Size	Appraised Value
Augelite	5 x 3.5 x 3 inches	$ 2,000
Lazulite	7 x 4.5 x 2 inches	7,500
Opal	550 carats	12,375
Peridot	103.23 carats	20,646
Tourmaline	5 x 5 x 5 inches	26,593
Wardite	6.5 x 3 inches	3,500
Wulfenite	16.5 x 8 x 4 inches	33,000 [2]
Rhodochrosite	3.25 x 3 inches	18,000
TOTAL		$123,614

In July of 1978, petitioner placed the large topaz crystal on loan to the Smithsonian. The Smithsonian did not place the crystal on public display. In October of 1978, petitioner obtained an appraisal of the topaz crystal which reflected a value therefor of $846,300. That value was based on the appraiser's opinion that the crystal successfully could be treated with the new radiation process and would yield approximately 10,578 carats (35 percent of its total weight) of irradiated blue topaz gemstones, which were selling in retail jewelry stores in October of 1978 for approximately $80 per carat.

In November of 1978, petitioner obtained a second appraisal of the topaz crystal which reflected a value therefor of $800,000. That value was based on the appraiser's opinion that the crystal, if successfully treated, would yield 10,075 carats (approximately 33 percent of its total weight) of irradiated blue

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2 The parties herein agree that the value of the Wulfenite stone in 1977 was $33,000.

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topaz gemstones which were then selling in retail jewelry stores for approximately $80 per carat. The $800,000 value reflected the appraiser's subtraction of $6,000 for cutting costs. On December 3, 1978, petitioner donated to the Smithsonian a 10-percent undivided interest in the topaz crystal.

In December of 1979, petitioner obtained two appraisals of the topaz crystal, each of which reflected that as of December of 1979, the retail price of irradiated blue topaz gemstones had increased from $80 to $100 per carat. Accordingly, the two appraisals obtained in 1979 reflected a fair market value for the topaz crystal of $1,057,800 and $1,000,000, respectively. On December 31, 1979, petitioner donated to the Smithsonian an additional 24.3-percent undivided interest in his topaz crystal.

In December of 1980, petitioner again obtained an appraisal of the topaz crystal, which reflected that the retail price of irradiated blue topaz gemstones had increased from $100 to $120 per carat. Accordingly, the appraisal reflected a fair market value for the crystal of $1,269,360. On December 31, 1980, petitioner donated to the Smithsonian an additional 23.6-percent undivided interest in his topaz crystal. At the time of trial, petitioner continued to hold approximately a 40-percent undivided interest in the topaz crystal.

On their 1977 amended Federal income tax return, petitioners claimed a charitable contribution deduction in the total amount of $348,614 for the jade desk set ($225,000) and the eight gem and mineral specimens ($123,614) donated to the Smithsonian in

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that year. Because of the 30-percent limitation of section 170(b)(1)(C), petitioners' charitable contribution deduction was limited to $196,400, and petitioners carried over to their 1978 Federal income tax return a charitable contribution deduction in the amount of $152,214. Petitioners' 1977 Federal income tax return is not at issue herein, and the proper value of the jade desk set and the eight gem and mineral specimens donated by petitioner in 1977 is in dispute only by virtue of the carryover of petitioners' claimed 1977 charitable contribution deduction to their 1978 return.

Petitioners reported on their Federal income tax returns for 1978, 1979, and 1980, a fair market value for the topaz crystal of $846,300, $1,057,800, and $1,269,360, respectively, and claimed a charitable contribution with respect to the percentage interests therein donated to the Smithsonian in each of the years, as follows:

Year	Percentage Interest in Topaz Donated	Amount of Claimed Charitable Deduction
1978	10.0%	$ 84,630
1979	24.3%	257,045
1980	23.6%	299,569

In his notice of deficiency, respondent disallowed the entire charitable contribution carryover from 1977 (attributable to the jade desk set and the eight specimens donated in 1977). Respondent also determined that the fair market value of the

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topaz crystal in each of the years in issue was $750 and allowed petitioners' deductions for the percentage interests therein donated to the Smithsonian in the respective amounts of $75, $182, and $177 for 1978, 1979, and 1980.

OPINION

The primary issue for decision relates to the amount of the charitable contribution deductions to which petitioners are entitled under section 170 for the contribution of the jade desk set, the eight gem and mineral specimens, and the topaz crystal to the Smithsonian.[3] With certain limitations not here applicable, if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property as of the date the property is contributed, reduced as provided in section 170(e)(1). Sec. 1.170A-1(c)(1), Income Tax Regs. The generally accepted definition of fair market value as set forth in respondent's regulations is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Sec. 1.170A-1(c)(2), Income Tax Regs. The proper market for purposes of determining the value of donated property is a question of fact to be resolved by

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[3] Sec. 170(a)(1) allows a deduction for a charitable contribution to an organization described in sec. 170(c). The Smithsonian so qualifies.

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considering all the relevant evidence in the record. Anselmo v. Commissioner, 757 F.2d 1208, 1213 (10th Cir. 1985), affg. 80 T.C. 872 (1983); Chiu v. Commissioner, 84 T.C. 722 (1985).

We first turn to the value of the 18-piece jade desk set donated to the Smithsonian in 1977. Petitioner purchased the desk set on March 3, 1977, for $55,000. Petitioner argues that the value of the desk set on December 23, 1977, the date of the contribution, was $225,000. Petitioner relies on an appraisal of the desk set made in conjunction with his purchase thereof which reflected a value for the desk set of $225,000. The author of that appraisal did not testify at trial.

Petitioner asserts that the desk set likely was crafted by Carl Faberge ("Faberge"), a famous Russian artisan. In support thereof, petitioner's expert witness at trial emphasized the overall quality of the desk set and pointed to one particular item from the set, a stamp moistener carved in the shape of a tomato, which was, in his opinion, virtually identical to an item from a jade desk set known to be crafted by Faberge. Although Faberge's work generally shows his signature markings, the jade items in petitioner's desk set show no signature markings.

Respondent argues that the value of the desk set in 1977 was no more than $55,000. Respondent presented testimony from an expert on the work of Faberge who stated that the desk set was not made by Faberge but was merely a poor copy of his work. Respondent also emphasizes that petitioner offered no explanation as to why Swaebe would sell to petitioner a jade desk set for

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$55,000 which Swaebe knew contemporaneously had been appraised at a value of $225,000. In that regard, petitioner testified only that he was "fortunate."

We previously have held that reliable evidence of the fair market value of a contributed item is the cost of the item to the taxpayers. Chiu v. Commissioner, supra at 734-735; see also Estate of Kaplin v. Commissioner, 748 F.2d 1109, 1111 (6th Cir. 1984), revg. a Memorandum Opinion of this Court. In the instant case, there is no credible evidence that in 1977 the value of the jade desk set exceeded $55,000, the price paid by petitioner therefor. Petitioner's assertion that the fair market value of the desk set was $225,000 is based primarily on the contention that the desk set was crafted by Faberge. Obviously, Swaebe held little confidence in the opinion of petitioner's appraiser, and neither do we. We accept the testimony of respondent's expert witness, a dealer of Faberge art work, who testified that the desk set clearly was not the work of Faberge. His opinion was based on a variety of reasons which included the type of jade used in the desk set, the design of the items, and particularly the craftmanship of the desk set.

Having determined that the value of the jade desk set in 1977 did not exceed $55,000, the issue herein regarding the value of the eight mineral specimens donated in 1977 is moot. As a result of the decrease in the amount deducted in 1977 to reflect the value of the jade desk set, petitioners' 1977 contributions do not exceed the contribution ceiling provided by the 30-percent

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limitation of section 170(b)(1)(c). Petitioners, therefore, are not entitled to any carryover to 1978 of charitable contributions made in 1977.[4]

With regard to the value of the topaz crystal donated to the Smithsonian in 1978, petitioner argues that because the topaz crystal could have been converted into a blue topaz crystal through a process of radiation and heat treatment and cut into finished gemstones which then could have been sold in retail jewelry stores, that potential use was the highest and best use of the topaz crystal and the crystal should be valued on that basis. The price for which irradiated blue topaz gemstones sold in jewelry stores at retail was $80 per carat in 1977, $100 per carat in 1978, and $120 per carat in 1980. Thus, based on the crystal's total asserted useable carat weight (after cutting) of approximately 10,578 carats, petitioner alleges that the fair market value of the topaz crystal was $846,300 in 1978, $1,057,800 in 1979, and $1,269,360 in 1980.

Respondent argues that the value of the topaz crystal did not exceed $750 in 1978, 1979, or 1980. First, respondent argues that petitioner's valuation method for the topaz crystal is

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[4] Contributions made by petitioners in 1977 as redetermined herein are as follows:

Jade Desk Set	$ 55,000
Eight Specimens	123,614
Total Contribution	$178,614
30-percent limitation	196,400
Amount of carryover	$ -0-

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erroneous because the crystal would not have been marketable to customers of retail jewelry stores in the form in which it was donated to the Smithsonian (i.e., as a 19-pound rough topaz crystal with a brown coloring). Respondent contends that petitioner could have sold the topaz crystal only to gem cutters or collectors, and that we must value the crystal according to the price it would bring in those markets, rather than in retail jewelry stores. Further, respondent emphasizes that the topaz crystal donated by petitioner herein was brown, not blue. Relying on the testimony of his expert witness on irradiation, respondent argues that at the time of the donation, the prospect of successfully converting the color of the topaz crystal through further treatments of radiation and heat was too remote and speculative to have influenced the value thereof. Respondent's expert witness appraised the value of the crystal as follows:

	VALUE AS OF:		
Markets	Dec. 3, 1978	Dec. 31, 1979	Dec. 31, 1980
Dealer/Cutter	$ 453.75	$ 589.88	$ 766.84
Collectors	2,831.25	3,419.64	4,190.62

After a thorough examination of all the facts and circumstances involved herein, we agree with respondent that the value of the topaz crystal in 1978, 1979, and 1980 did not exceed $750. As we previously stated, the choice of market in which to value contributed property is a question of fact. Anselmo v. Commissioner, supra. Petitioner's experts concede that the topaz

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crystal would not have been sold in retail jewelry stores in the form in which it was donated, but most commonly would have been sold to gem cutters or collectors. Nevertheless, petitioner argues that we must value the crystal as if it already had been converted to a blue topaz crystal, cut into small gemstones which then would be available for sale in retail jewelry stores. In 1977, however, the radiation and heat treatment was still in the experimental stage. Only one individual, petitioner's expert, actually was experimenting with the process, and he testified that during the year before us he was not irradiating gemstone specimens owned by other individuals, such as petitioner. We therefore are not convinced that the slight possibility of enhancing the color of petitioner's topaz crystal was sufficient to cause the value of the crystal to increase from $750 to over $1.2 million between 1972 and 1980, as petitioner's experts suggest.

We are not bound by the opinion of an expert witness, and we may embrace or reject expert testimony, whichever, in our best judgment, is appropriate. Helvering v. National Grocery Co., 304 U.S. 282 (1938); Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. a Memorandum Opinion of this Court. That is our job and our duty. Because petitioner's experts appraised the topaz crystal with regard only to its value as irradiated blue topaz gemstones sold at retail, those opinions are not a reliable

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basis from which to determine the value of the topaz crystal as it existed in 1977, 1978, and 1979 (and as it still exists today).

Respondent's value for the topaz crystal of $750 is close to the values reported by his expert witness and is identical to the acquisition price of the crystal in 1972. We find that the value of the topaz crystal was $750 on each of the relevant valuation dates.

By amendment to his answer, respondent raised an additional issue concerning the application of the increased rate of interest on substantial underpayments attributable to tax motivated transactions under section 6621(d).[5] The increased

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[5] (d) **Interest on Substantial Underpayments Attributable to Tax Motivated Transactions.--**

> **(1) In general.**--In the case of interest payable under section 6601 with respect to any substantial underpayment attributable to tax motivated transactions, the annual rate of interest established under this section shall be 120 percent of the adjusted rate established under subsection (b).
>
> **(2) Substantial underpayment attributable to tax motivated transactions.**--For purposes of this subsection, the term "substantial underpayment attributable to tax motivated transactions" means any underpayment of taxes imposed by subtitle A for any taxable year which is attributable to 1 or more tax motivated transactions if the amount of the underpayment for such year so attributable exceeds $1,000.
>
> **(3) Tax motivated transactions.**--
>
> **(A) In General.**--For purposes of this subsection, the term "tax motivated transaction" means--

(footnote continued)

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interest rate applicable under section 6621(d) is 120 percent of the interest rate otherwise applicable to income tax underpayments under section 6621(b). Where applicable, the increased interest rate provided in section 6621(d) applies with respect to interest accruing after December 31, 1984. Deficit Reduction Act of 1984, sec. 144(c), Pub. L. No. 98-369, 98 Stat. 682; The Stanley Works and Subsidiaries v. Commissioner, 87 T.C. ___ (August 12, 1986).

Transactions considered to be "tax motivated transactions" under section 6621(d) are set forth in section 6621(d)(3) and include a "valuation overstatement" as defined in section 6659(c). Section 6659(c) provides that a valuation overstatement is present if the value of any property, or the adjusted basis of any property, claimed on a return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis, as the case may be.

(footnote continued from previous page)

(i) any valuation overstatement (within the meaning of section 6659(c)),

(ii) any loss disallowed by reason of section 465(a) and any credit disallowed under section 46(c)(8),

(iii) any straddle (as defined in section 1092(c) without regard to subsections (d) and (e) of section 1092), and

(iv) any use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period.

* * *

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In the instant case, petitioners valued the topaz crystal at $846,300, $1,057,800, and $1,269,360 on their Federal income tax returns for 1978 through 1980. In light of our determination that the value of the topaz crystal did not exceed $750 during the years in issue, a valuation overstatement was made on petitioners' returns, and petitioners are liable under section 6621(d) for the increased rate of interest on substantial underpayments of tax attributable thereto. We so hold.

Decision will be entered for the respondent.

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JU11.7/2: 1986-434

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T. C. Memo. 1986-434

UNITED STATES TAX COURT

ROBERT F. GODBEY AND MARY N. GODBEY, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 33225-85. Filed September 15, 1986.

Robert F. Godbey, pro se.

Cheryl M. D. Rees, for the respondent.

MEMORANDUM OPINION

GUSSIS: Special Trial Judge: This case was assigned pursuant to section 7456(d) of the Internal Revenue Code and Rules 180, 181, and 182, Tax Court Rules of Practice and Procedure.[1]

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. All Rule references are to the Tax Court Rules of Practice and Procedure.

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Respondent determined (1) a deficiency in petitioners' Federal income tax for 1981 in the amount of $1,938; (2) an addition to tax under section 6653(a)(1) in the amount of $96.90; and (3) an addition to tax under section 6653(a)(2) in the amount of 50 percent of the interest due on the underpayment of $1,938. The issues are (1) whether a payment of $5,000 to petitioner Robert F. Godbey in 1981 is includable in gross income under section 61(a) or represents a nontaxable loan, and (2) whether petitioner is liable for the additions to tax under sections 6653(a)(1) and (2) for negligence or intentional disregard of rules and regulations.

Some of the facts have been stipulated and they are herein incorporated by this reference. Petitioners resided in Trinity, Texas at the time the petition herein was filed.

Prior to his retirement in 1981 petitioner Robert F. Godbey was a district chief in the Houston Fire Department. In February 1981 Paul C. White, Jr. (hereinafter White), who was also a member of the Houston Fire Department, was on a promotion list of persons eligible for promotion to the rank of district chief. Vacancies at the rank of district chief were filled in the order of appearance on the promotion list. Placement and ranking on the promotion list were determined by an individual's score in a competitive examination. Each promotion list remained in effect for one year. In the event an individual on the current promotion list failed to get a promotion prior to the expiration

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of said list, it would be necessary for such individual to again qualify for a new promotion list in another competitive examination. Promotion lists were widely distributed throughout the Houston Fire Department.

At the time the promotion list in effect in February 1981 was initially published, White ranked seventh. By February 1981 approximately four or five of the individuals ahead of White on the list had already been promoted. The promotion list was due to expire on February 14, 1981. Due to rumors of planned retirements, While believed that if one more district chief retired or resigned prior to the expiration of the promotion list he would receive his promotion.

On February 4, 1981 petitioner met with White who delivered a check to petitioner in the amount of $5,000. On or about February 4, 1981 petitioner and White executed a document which stated that "I P.C. White am making a personal loan to Robert F. Godbey payable on February 2, 2011 at an annual interest of 1% per year." Prior to discussions with White with respect to the payment of $5,000, petitioner had planned to retire in or about November 1981. Petitioner retired prior to February 14, 1981 and White was promoted to the rank of district chief on February 14, 1981.

Respondent determined that the amount of $5,000 which petitioner received from White in February 1981 constituted taxable income under the provisions of section 61(a). Petitioner

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argues that he obtained a loan of $5,000 from White which would not be includable in gross income. Petitioner has the burden of proof. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Whether a bona fide debtor-creditor relationship exists is a question of fact to be determined upon a consideration of all the pertinent facts. "An essential element is the intent of the recipient to make monetary payment of the amount of the advance and the intent of the person advancing the funds to enforce such payment." Beaver v. Commissioner, 55 T.C. 85, 91 (1970).

Upon a consideration of the whole record it is our conclusion that a bona fide debtor-creditor relationship was not created as a result of the payment of $5,000 to petitioner in February 1981. To the contrary, the facts overwhelmingly indicate that the payment was made to petitioner by White solely to induce petitioner to retire from the fire department prior to the expiration of the promotion list, i.e., prior to February 14, 1981. Upon petitioner's retirement White achieved the desired result, i.e., he was promoted to the rank of district chief on February 14, 1981. White testified that he could not recall any discussions with petitioner about the terms of the so-called note (payable in the year 2011 with an annual interest rate of one percent). In fact, it appears that White was wholly indifferent to the terms appearing on the document. He also testified quite candidly that he did not expect repayment of the amount of $5,000 and further admitted that he had no intention of enforcing

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payment of either the $5,000 or the purported interest. He testified that as of the date of the trial he had received no payment of principal or interest from the petitioner.

The true nature of the transaction between petitioner and White is underscored by the testimony of Douglas Hamel, the chairman of the civil service commission of the city of Houston. An investigation by the civil service commission revealed that it had been the practice within the fire department over a period of some years to pay service officers to retire and thus pave the way to promotion pursuant to a current eligibility list. This practice obviated the need to take a new competitive examination after the expiration of the current eligibility list. The commission also discovered that the payments made to induce retirement seemed to hover around the amount of $5,000. After the hearings, the civil service commission ordered certain amendments in the commission's rules governing members of the Houston fire and police departments designed to eliminate this longstanding practice. In our view, White's payment of $5,000 to petitioner in 1981 simply followed the prevailing practice, i.e., it was made to induce petitioner to retire prior to the expiration of the current eligibility list. We conclude under

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these facts that the payment of $5,000 is includable in petitioner's taxable income in 1981.[2]

The next issue is whether petitioner is liable for additions to tax under sections 6653(a)(1) and (2) for negligence or intentional disregard of rules and regulations. Petitioner has the burden of proof. Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972). In the absence of any persuasive evidence on this issue, we must sustain the respondent's determination as to the additions to tax under sections 6653(a)(1) and (2).

Decision will be entered for the respondent.

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2 Although petitioner at one point in his testimony stated that the payment he received was "either loan or gift," he made no serious effort to pursue the gift argument. In any event, the contention that the payment of $5,000 to petitioner constituted a nontaxable gift (see section 102) is utterly without merit. The Supreme Court has defined a gift within the meaning of the Internal Revenue Code as a transfer that arises from a "detached and disinterested generosity." Commissioner v. Duberstein, 363 U.S. 278, 285 (1960). White's intention in making a payment of $5,000 to petitioner can hardly be described under the circumstances here present as "detached and disinterested."

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JU 11.7/2: 1986-435

ORIGINAL

T. C. Memo. 1986-435

UNITED STATES TAX COURT

JAMES P. AND MURIEL F. KELLSTEDT, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9883-84. Filed September 15, 1986.

James P. Kellstedt, pro se.

Matthew J. Fritz, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, Judge: Respondent, by a statutory notice of deficiency dated January 11, 1984, determined a 1979 taxable year deficiency in Federal income tax in the amount of $31,755 and additions to tax under sections 6651(a)[1] and 6653(a) in the amounts of $7,939 and $1,588, respectively.

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1 Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

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James P. and Muriel F. Kellstedt (petitioners) are husband and wife and resided at Peoria Heights, Illinois, at the time of filing the petition. Some of the facts have been stipulated, and the stipulation and supplemental stipulation of facts and exhibits attached thereto are incorporated herein by this reference. The parties have resolved by settlement, reflected in the stipulations and in the record, many of the issues set forth in the statutory notice, leaving for the Court's consideration questions of the substantiation of several deduction items connected with James P. Kellstedt's (petitioner) law practice, certain real property, and certain personal deductions. Additionally, petitioners contest both additions to tax under sections 6651(a) for late filing and 6653(a) for negligence or intentional disregard of the rules and regulations. For purposes of order and clarity, each of the issues submitted for our consideration will be separately set forth with facts and opinion.

"Advertising, Entertaining & Travel" Expense

Petitioner claimed $10,861.04 for "advertising, entertainment & travel" expenses on his 1979 Schedule C concerning reported income and deductions from his law practice. Respondent, in the statutory notice, disallowed $7,415 of the amount claimed which represented entertainment expenditures for which petitioners had not met the requirements of section 274. The parties have stipulated that $6,737 of the $7,415 disallowed

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was paid to Mt. Hawley Country Club, VISA, Petros Steak House or Jim's Steak House. Two hundred fifty dollars was paid to St. Andrews Episcopal Church[2] on July 16, 1979. At trial petitioner submitted numerous canceled checks which, on brief, he segregated as to various restaurants, VISA, etc. which totaled $17,178.19.

Petitioner argues that he claimed only a part of his total entertainment expenses for 1979 and that at least $6,988[3] is deductible. Petitioner explained that the amounts were expended on clients and employees. In support of petitioner's position, the record consists of canceled checks and petitioner's uncorroborated and generalized testimony, which was devoid of any detail or specifics.

Respondent contends that petitioner has not met the requirements of section 274(d) and regulations thereunder, and that petitioner also has not carried his burden of showing entitlement to deductions for purchasing meals for employees. We agree with respondent. To the extent that petitioner made payments for entertainment of clients, section 274(d) would deny a deduction unless petitioner "substantiates by adequate records

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2 Petitioner has contended that this $250 check showing a church as payee should provide the basis for a contribution deduction. We are somewhat at a loss how it became a part of advertising, entertainment or travel, but more importantly, petitioner has not shown that this amount was paid as a contribution or the donative intent of the payment.

3 We are somewhat at a loss as to how petitioner computed that he was entitled to deductions of $6,988 in excess of the $3,446.04 allowed by respondent. The differences between the amount claimed and disallowed is of no consequence because of petitioner's failure to properly substantiate the $6,988 additional amount under secs. 274 or 162.

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or by sufficient evidence corroborating his own statement * * * the time and place of the * * * entertainment, * * * the business purpose of the expense, * * * [and] the business relationship * * * of the persons entertained * * *." Petitioner seeks refuge from these rigorous requirements in Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930), but it is clear that Cohan does not apply to the expenses covered under section 274. See Sanford v. Commissioner, 50 T.C. 823, 827-828, affd. per curiam 412 F.2d 201 (2d Cir. 1969), cert. denied 396 U.S. 841 (1969).

To the extent that petitioner relies upon section 274(e) regarding these claimed deductions, we detect only possible relevance to meals or entertainment provided employees. Initially, we would have no way of recognizing which, if any, of the expenditures were for employees' meals or entertainment. Further, the circumstances and specifics of each occasion have not been provided. Section 274(e)(2) would appear to permit a deduction for food and beverages served to employees on business premises in appropriate circumstances. The record does not provide sufficient information to determine whether petitioner's expenditures were for a purpose that would come within section 274(e). Respondent argues, and we see some merit to the argument, that it appears that the receipts are for restaurants off the business premises and may not qualify for that reason. Even if petitioner had paid for employees' meals in connection with luncheon meetings, there is some question as to whether those expenditures would be deductible. See Moss v.

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Commissioner, 758 F.2d 211 (7th Cir. 1985), affg. 80 T.C. 1073 (1983).

Accordingly, we find that petitioner has failed to carry his burden of proving entitlement to "advertising, entertainment & travel" in excess of the $3,446.04 allowed by respondent. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Amount of Capital Gains from "East Samuel Property" - Calculation of Basis and Year of Includability of Down-Payment

On their 1979 return, petitioners reported the sale of the 1226-8 East Samuel realty for a selling price of $148,995.66, along with a $70,000 adjusted basis, thereby reflecting a long-term capital gain of $78,995.66. Respondent, in the statutory notice, determined a $111,000 long-term capital gain based upon a $155,000 sales price and $44,000 adjusted basis. Respondent has now conceded that petitioners are entitled to reduce the sales price by $1,157.34 in selling expenses and increase the adjusted basis by $3,183.90.

The remaining differences between the parties are attributable to a $5,000 downpayment received in 1978 and not reported as part of the selling price in 1979 and various improvements that petitioners claim were made since acquisition of the East Samuel property. It is not clear from petitioners' briefs whether they contest the $5,000 downpayment aspect of this case. Petitioners have not shown this to be an installment sale so as to permit reporting of the transaction over several taxable

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years. The recognition of gain by petitioners should occur upon the consummation of the sale, which occurred in 1979. The down-payment of $5,000, received in December 1978, is to be considered part of the sales price for the purpose of the computation of gain in the circumstances of this case. Bourne v. Commissioner, 23 B.T.A. 1288, 1293-1294 (1931), affd. 62 F.2d 648, 649 (4th Cir. 1933), cert. denied 290 U.S. 650 (1933). See also Westrom v. Commissioner, T.C. Memo. 1966-198, involving an Illinois taxpayer who received $5,000 earnest money in a prior year which was treated as conditional until the year the sale was consummated.

The remaining aspect of the East Samuel property is the adjusted basis for purpose of determining gain. The sales price was $153,842.66 and petitioner purchased East Samuel in 1973 for $44,000, composed of 2 separate parcels for $22,000 each. When purchased, each of the parcels had a building upon it. Petitioner razed 1 of the 2 buildings and used the other for his law office. The site of the razed building was prepared and used as a gravel-paved parking area. Respondent agrees to the $44,000 cost and an additional $3,183.90[4] basis, for a total basis of $47,183.90. Petitioners have presented only broad generalizations by means of testimony about expenditures to improve the East Samuel property. Petitioners apparently sold

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[4] The parties have provided no explanation as to the improvements or specific expenditures which comprise the $3,183.90 concession by respondent to increase petitioners' basis in the East Samuel property.

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the East Samuel property to a bank or some other adjacent commercial establishment for use as a parking lot. In preparation for this use and sale in 1979, petitioner arranged at a cost of $9,800[5] to move his former law office building from East Samuel to another location. The expenditures to prepare, move and affix the building to the new plot of land are certainly not includable in petitioners' basis to compute gain from a sale, for the building has been retained for petitioners' use or sale at another location.

Essentially, petitioners would be entitled to include in basis the cost of demolition of the second building and grading of the parking area, to the extent that those items were not previously expensed or capitalized and depreciated. Unfortunately, petitioners have failed to carry their burden of showing the amounts attributable to those improvements or that said improvements were not already a part of the $3,183.90 conceded or agreed to by respondent. Welch v. Helvering, supra; New Colonial Ice Co. v. Helvering, supra; Rule 142(a). We therefore find that petitioners have failed to show that their basis in the East Samuel property was more than $47,183.90 or that the sales price was less than $153,842.66.

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5 Although petitioners claimed over $30,000 in increases to basis of the East Samuel property, documentary evidence was provided which corroborated a $4,800 payment to Fred Bologna on Oct. 18, 1979, as the second payment on a $9,800 contract price to move the East Samuel building to another location and the payment of $15.10 to the Village of Peoria Heights for a building moving permit.

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Depreciation -
1215 East Duryea Property

Respondent disallowed $2,200 of depreciation claimed by petitioners with respect to a duplex family housing structure located at 1215 East Duryea for the reason "that the property was [not] used in a trade or business or in the production of income." The property had been rented to a Mrs. Hibbert. Early in 1979, there was a dispute concerning whether the tenant or landlord was responsible under the lease agreement to pay for furnace repairs. In connection with the disagreement, Mrs. Hibbert moved out and petitioners had difficulty renting the property during the remainder of 1979.

Respondent argues that section 1.167(a)-10(b), Income Tax Regs., would prohibit a depreciation deduction when an "asset is retired from service." We are unable to find that petitioners retired this property from service during 1979 and, accordingly, hold that petitioners are entitled to deduct $2,200 of depreciation for 1979 regarding the rental property located at 1215 East Duryea.

Rental Expenses - Provincetown and
1230 East Duryea Properties

With respect to the 1230 East Duryea property, petitioners reported $1,200 of rents and claimed $1,650 and $225 for depreciation and expenses, respectively, representing petitioners' one-half interest in the property during 1979. Respondent, in the statutory notice disallowed $50 of the

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depreciation and the $225 in claimed rental expenses. Respondent, by stipulations, agreed to allow an additional $50 in depreciation. At trial, petitioners presented evidence of expenditures connected with this rental property and now claim total rental expenses of $1,114.21.[6] Based upon petitioner's testimony and Exhibits 17, 18, 19, 32 and 37, we find that the following ordinary and necessary non-capital expenditures were made in connection with the 1230 East Duryea property: Utilities--water, $32.55; insurance, $134; and repairs, $733. Accordingly, petitioners have carried their burden of proving $899.55 in rental expenses and are entitled to deduct $449.78 in connection with the 1230 East Duryea property for 1979, an amount which exceeds respondent's disallowance by $224.78.

With respect to the Provincetown property, petitioners reported no rents and claimed $750 and $250 for depreciation and expenses, respectively, during 1979. Respondent, in the statutory notice, disallowed the $250 in claimed expenses. Respondent now contends that he should not have allowed the $750[7] claimed by petitioners for depreciation, because petitioners have not shown that the property was not held for personal use and was held for the production of rental income. At trial petitioners

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6 Due to petitioners' one-half ownership interest in the 1230 East Duryea property, they would only be entitled to one-half of any deductible expenditures.

7 On brief respondent declines to raise the $750 depreciation issue "to avoid injecting yet another new issue * * * at this late date * * *."

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presented evidence of expenditures connected with the Provincetown property and now claim $801 in rental expenses.

This real property consists of two buildings on the same lot used by petitioners for personal purposes. Apparently there is a larger single-family dwelling, used exclusively by petitioners for personal purposes, and a separate building, referred to as the "studio," consisting of 3 rooms and a bath. Five hundred eighteen dollars of the $801 in claimed expenses represent a one-sixth proration of numerous alleged expenditures which petitioners have failed to segregate as to the main dwelling or the studio.[8] Further, petitioners have failed to show that these expenditures were non-capital in nature so as to be currently and fully deductible. With respect to the remaining $283 of expenditures for utilities and "bowls and trays," petitioners have failed to carry their burden of showing that the studio was held out for rental or the production of income because of admitted personal use and no credible evidence of rentals or efforts to rent the property. Johnson v. Commissioner, 59 T.C. 791, 813-815 (1973), affd. without discussion of this point 495 F.2d 1079 (6th Cir. 1974). Accordingly, we find that petitioners are not entitled to the $250 claimed on the return or any additional amounts of alleged expenses (1) because any expenses

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[8] It may be appropriate to prorate expenditures by a percentage based upon area or some other measure where one is attempting to allocate overall expenditures attributable to a room or portion of a larger building, but we find petitioners' approach inappropriate in this case where there are two separate buildings.

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incurred were not connected with property held for the production of income and (2) partially for failure to prove any expenditures were allocable to the studio.

Interest Deductions

Petitioners claimed $18,060.56 in interest expense as part of their itemized deductions from adjusted gross income. Respondent, in the statutory notice allowed only $3,364.56[9] as an itemized interest deduction. In the stipulation of facts, respondent agreed that petitioners were entitled to $6,978.89 additional allowable interest. Likewise, in a supplemental stipulation of facts, respondent agreed to more allowable interest in the amount of $4,335.63. At the beginning of the trial, respondent's counsel orally stipulated that petitioners were entitled to yet another $841.34 in allowable interest deductions. Therefore, going into the trial, petitioners' $3,364.56 statutory notice allowance increased to $15,520.42. Considering the $18,060.56 claimed, petitioners' burden was to show an additional $2,540.14 to reach the original amount of interest deducted for 1979.

In an attempt to substantiate some part of the $2,540.14 difference, petitioners, on brief, argue for allowance of the following amounts: (1) $750--Mass. Mutual Insurance Co.;

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9 Respondent rounded off to the nearest dollar in the statutory notice, which may account for a few cents difference between the petitioners' return, the briefs, and this opinion. Because our opinion finds specific amounts, the specific amounts are to be used for any calculation under Rule 155.

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(2) $184--credit cards; (3) $1,948 more than $4,300 respondent already allowed for Illinois Mutual; (4) $493 more than the $1,100.62 respondent allowed or petitioners originally claimed for Chillicothe Federal; and (5) $40 more than the $79.93 respondent allowed for Madison Park Bank. With respect to all items other than "Mass. Mutual Insurance Co.," petitioners have failed to come forward with evidence from which we could find amounts of interest allowable in addition to the $15,520.42. Welch v. Helvering, supra; Rule 142(a).

With respect to "Mass. Mutual Insurance Co.," petitioner produced a check dated "12/27" and canceled January 10, 1979, to "Mass. Mutual Life Ins." in the amount of $375. Petitioners claimed $750 regarding a loan upon an insurance policy for which interest payments were made twice each year. We agree with respondent that petitioners reported on the cash basis, as reflected in their 1979 return, and the $375 check was issued in 1978, a fact that petitioners have not denied. On the other hand, the one check coupled with petitioner's testimony is sufficient to permit our allowance of one $375 payment made by petitioners during 1979. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). Accordingly, we find that petitioners are entitled to an interest deduction of $15,895.42 for the taxable year 1979.

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Medical and Dental Expenses

Petitioners claimed, without considering the 1 and 3-percent limitations, $1,760, $897.73 and $899.69 for medicine, doctors and dentists, and other medical items on Schedule A of their 1979 return. Respondent, in the statutory notice, disallowed the entire amount claimed because petitioners did not show the amounts were expended at all or for the purpose claimed.

Petitioners, on brief, summarized their view of the evidence in the record supporting the deduction of the following proposed amounts: Medicine--$2,753.76; doctors, etc.--$786; hospital--$160; and "Other"--$627.40. Respondent, on brief, conceded that the record supports petitioners' summary amounts of $786 for doctors and $627.40 for "Other."

The first of the 2 remaining items in dispute involves a $160 amount concerning St. Francis Hospital Medical Center. The only evidence offered by petitioners is a receipt[10] for a personal check in the amount of $160 regarding Florence Kellstedt, who is petitioner's mother and claimed as a dependent on petitioners' 1979 return. Petitioners have offered no other documents or testimony to show that the payment was made by them and/or that the payment was made during 1979. Accordingly, we find that petitioners have failed to carry their burden of substantiating this claimed amount. Welch v. Helvering, supra; Rule 142(a).

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10 The receipt is part of composite Exhibit 28 and appears on the upper left corner of the first page of the exhibit.

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The other unagreed "medical" item concerns medicine and drugs. Petitioners only claimed $1,760 on their return and, on brief, now claim $2,753.76 for medicine and drugs. The conduct of the trial and the parties' briefing of this item was confused due to petitioners' poor organization of the materials. Although respondent has made limited concessions,[11] it will be necessary to review and summarize Exhibits 21, 27 and 28, which consist of a mixture of unorganized documents. The documents may be categorized into 3 general categories: (1) Checks, sales slips and memoranda regarding vitamins; (2) checks, receipts and prescriptions from Smith Drug Store; and (3) petitioners' ledger sheet for the period June 1, 1979, through August 31, 1979, from Smith Drug Store.

Petitioner was under the care of a doctor for several physical problems which required vitamins as part of the doctor's recommended treatment. With the exception of vitamins that may have been purchased at Smith Drug Store, petitioners' vitamin purchases amounted to $167.28. This allowance is reflected in Exhibits 21 and 28 by checks numbered 040 and 1663 and page 6 of Exhibit 28. The remaining documentation which petitioners have advanced to support the additional purchase of vitamins is unspecific and uncorroborated and therefore not persuasive. Moreover, it is difficult to determine which of the vitamins purchased were for petitioner's health rehabilitation and which

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[11] Respondent conceded $32.94 ("Edna's Health" and "Mats Pharm") and $205.92 from Exhibit 28.

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petitioners consumed for non-medical purposes or merely for their own self-imposed purposes. Lingham v. Commissioner, T.C. Memo. 1977-152.

Regarding Smith Drug Store, petitioners provided 8 canceled checks[12] totaling $1,592.88. Petitioners also provided a 3-month running ledger account of their purchases at "Smith" during June 1 through August 31, 1979. The purchases for the 3-month period totaled $491.87 without considering sales tax, and we determined that $318.73 of the purchases were for medicine or drugs connected with petitioners' health problems. As a percentage, petitioners' purchases at "Smith" during the 3-month period were, on the average, 65 percent "tax" deductible items. Based upon petitioner's testimony, some corroborating evidence of prescriptions having been filled at "Smiths," and the record regarding these items, we find that 65 percent of the $1,592.88 paid to Smith Drug Store or $1,035.37 is deductible for 1979 (subject to the 1 and 3-percent limitations) by petitioners as medicine and drugs. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).

Accordingly, we find petitioners have carried their burden with respect to $1,202.65 ($1,035.37 plus $167.28) of medicine and drugs for the taxable year 1979.

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12 There were several duplicate photocopies of checks to Smith Drug Store.

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State and Local Tax - "Water Tax"

Petitioners contend that they pay an annual "tax" ($56 during 1979) to the local municipality in exchange for water and a "hookup" supplied by the municipality. Section 164 provides for the allowance of a deduction for State and local taxes, but the type of "tax" petitioners contend they paid does not fit within the specified categories. Further, the "tax" as described by petitioner is not an ad valorem tax but is more like an annual charge or fee in exchange for water service. Mahler v. Commissioner, 119 F.2d 869, 873 (2d Cir. 1941), cert. denied 314 U.S. 660 (1941). Accordingly, petitioners' claimed "water tax" is not deductible for their 1979 taxable year.

Self-Employment
Retirement Plan - Keogh Plan

Petitioners did not claim a deduction for a contribution to a Keogh plan on their 1979 return.[13] At trial and on brief, petitioners now seek a $3,500 deduction for an alleged contribution to a Keogh plan. In support of the claimed deduction, petitioners offered an unexecuted copy of a January 1, 1984, amendment of a December 31, 1971, Keogh plan with Jefferson Trust and Savings Bank and a $3,500 check to the bank dated April 16, 1979.

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13 We are not surprised that petitioners did not claim a deduction for a contribution to a Keogh plan because petitioners did not have any "earned income" from self-employment within the meaning of sec. 404(e)(1), limiting the deduction to 15 percent of "earned income," and sec. 401(c)(2), defining "earned income" as net earnings from a business in which personal service is a material income-producing factor. For 1979, petitioners reported a $13,909.71 loss from the practice of law on Schedule C.

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Respondent contends that petitioners have properly shown the terms of their 1979 Keogh plan but that, under the facts presented, the $3,500 check was for petitioners' 1978 taxable year because the check payment made to the bank was dated April 16, 1979, the last possible date[14] for a 1978 contribution to a Keogh plan. See sec. 404(a)(6). We find that petitioners' evidence does show that they participated in a Keogh plan, but we agree with respondent that petitioners have not carried their burden of showing payment to a qualified plan for the 1979 taxable year. Welch v. Helvering, supra; New Colonial Ice Co. v. Helvering, supra; Rule 142(a).

Sec. 6651(a) - Addition to Tax
for Failing to Timely File a Return

Section 6651(a) provides for a 5-percent per month (not to exceed 25 percent) addition to tax where failure to file is not due to reasonable cause and is due to willful neglect. Petitioners sought and received 2 extensions within which to file their 1979 U.S. Individual Income Tax Return for the calendar year 1979. The return was due April 15, 1980, and the time was extended to October 10, 1980, by means of the 2 granted requests for extensions. Petitioners' 1979 return was signed on "2/81" and filed on or about February 28, 1981.

In their application for extension of time granted July 1, 1980, petitioners cited the press of business and personnel

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14 April 15 fell on a Sunday in 1979 and April 16, 1979, was the last date for timely filing of a calendar year Federal return of income without extensions. Secs. 6072(a) and 7503.

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problems as reasons for the extension. At trial and on brief, petitioner additionally contended that the general condition of his health was poor. We cannot accept petitioners' reasons as reasonable cause. After 2 extensions, petitioners filed a return over 4 months later than the extended time. Furthermore, petitioners' case was petitioned to this Court more than 3 years after filing the return and was continued from a March 18, 1985, trial session to a special session August 6, 1985, and petitioner had not yet organized his documentation for a tax return filed some 4-1/2 years before. We find that petitioners have exhibited a propensity to be dilatory and that there was not reasonable cause for that pattern of conduct in connection with the filing of their 1979 return. Dustin v. Commissioner, 53 T.C. 491, 500-501 (1969), affd. 467 F.2d 47 (9th Cir. 1972).

Sec. 6653(a) - Addition to Tax
for Negligence or Intentional
Disregard for Rules and Regulations

As discussed in connection with the addition to tax for late filing, petitioners were dilatory in organizing their supporting documentation in support of the items on their return. In addition, many of petitioners' claimed deductions were estimates. Petitioner points out that in some instances the evidence reflected that he was entitled to more than he claimed. Respondent, however, cogently points out that petitioners' evidence fell far short of the mark on numerous deductions. Petitioner's slovenly and inadequate bookkeeping constitutes an

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appropriate reason for respondent to determine an addition to tax under section 6653(a) and we so hold. Petitioner, as an attorney, should be aware of his obligation to maintain proper records in connection with income tax matters. Petitioners have failed to carry their burden of showing that they exercised proper care in preparation of their 1979 return. Cobb v. Commissioner, 77 T.C. 1096, 1101-1102 (1981), affd. by unpublished order 680 F.2d 1388 (5th Cir. 1982).

To reflect the foregoing,

Decision will be entered under Rule 155.

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JU 11.7/2: 1986-436

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T. C. Memo. 1986-436

UNITED STATES TAX COURT

RONALD G. LEWIS AND KATHIE A. LEWIS, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 20187-84. Filed September 15, 1986.

B. Mahlon Brown, for the petitioners.

Kenneth A. Burns, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined deficiencies in and additions to petitioners' income taxes as follows:

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Year	Deficiency[1]	Additions to Tax Section 6653(a)[2]
1980	$8,532.08	$ 426.65
1981	6,761.00	338.05, plus 50% of interest on an underpayment of $5,000

After concessions, the only issue remaining for decision is whether petitioner failed to comply with respondent's toke compliance program and, if so, whether the failure relieves respondent of his obligations to petitioner.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by reference.

Petitioners, Ronald G. and Kathie A. Lewis, husband and wife, resided in Las Vegas, Nevada, at the time they filed their petition. They filed joint income tax returns for 1980 and 1981 with the Internal Revenue Service Center at Ogden, Utah.

During 1980 and 1981, Kathie A. Lewis ("petitioner") was employed as a twenty-one dealer at Caesar's Palace ("Caesar's"). It is undisputed that her toke income was underreported on the returns for both years.

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1 The parties stipulated that the deficiencies for each year shall be $5,000 in the event this Court rules that petitioners are not relieved of their 1980 and 1981 tax liabilities.

2 All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

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During 1980 and 1981, respondent instituted in Nevada a toke compliance program in an attempt to stop a tax loss estimated to be in excess of $100,000,000 per year from the failure of casino dealers to fully and accurately report their toke income. The program was designed to conserve respondent's Nevada audit resources while achieving an increase in the compliance by the dealers with the tip reporting requirements of the Internal Revenue Code. In general terms, under the discretionary program, the Service agreed not to audit a dealer's pre-1982 returns if the dealer fully participated in the program.

On October 15, 1981, the local examination group manager for respondent sent a letter to all of Caesar's dealers informing them of the toke compliance program. The pertinent provisions of the letter are set out below:

> In September of this year, Internal Revenue Service initiated a payroll tax audit of your employer's tax return. Your employer was required by law to provide the information requested in connection with this payroll tax audit. As in any normal audit, the procedures included a review of the payroll records of all employees including dealers. It is the intention of the Service to use information gathered not only for a determination of the correct payroll tax of your employer, but also for the conduct of a dealers' toke project.
>
> In the alternative, the Internal Revenue Service is willing to enter into an agreement with Caesar's Palace Dealers whereby current compliance with the tax laws can be achieved without conducting a toke project. You will not be audited if you agree to begin currently reporting 100 percent of your tokes under an acceptable plan. Examples of acceptable plans are as follows:

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* * *

PLAN FOR DEALERS WHO DO NOT POOL TOKES, SUCH AS POKER AND CRAPS DEALERS OR DEALERS WHO POOL VOTE NOT TO ADOPT A REPORTING SYSTEM FOR THE GROUP:

> You would be allowed to report your tips individually. The individual method requires the reporting of toke income on a monthly basis to the IRS. The law requires that if you make more than $20 per month in tokes that you report them to your employer by the 10th of the following month. If you would be uneasy about reporting your tokes to your employer because of peer pressure, you may report to us and make quarterly estimated tax payments. If you do not pool tokes or the dealers in your casino do not accept a group reporting system by the compliance date, contact the IRS at 385-6362 if you want to comply.

Upon notice to the IRS of your participation in either method of current compliance, you will receive a letter from the District Director stating that in return for current compliance, the Internal Revenue Service will not start an audit of your tax return for toke income for 1978, 1979, 1980 or 1981 from January 1, 1981 through the date when 100 percent reporting starts.

The tax savings are significant. The estimated average deficiency and penalties for any given year are over $5000.000 [sic] per year. If current compliance is not achieved, the Internal Revenue Service will be forced to pursue an information gathering project to determine toke income for past and current years.

* * *

We will be holding meetings for the dealers from your hotels to discuss this proposal. You may attend whichever meeting is more convenient for you. If you have any questions, you may ask them at the meeting or call us at 385-6362.

Our primary goal is current compliance.

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Subsequently, petitioner received a second letter from respondent's acting group manager which stated in pertinent part as follows:

> You were among the dealers at several hotels contacted by the Internal Revenue Service in 1981 regarding the dealer toke compliance plan. The deadline to enter into the plan on an individual basis was December 10, 1981. Many dealers have informed the Internal Revenue Service that there was confusion among the dealers because they had received conflicting information and therefore, they did not realize that December 10th was the last day they could enter into the compliance plan on an individual basis. Although group compliance systems could be instituted after December 10th, many dealers have informed us that they could not get a majority of dealers organized to start a group system.
>
> Since many dealers who may have wanted to enter the compliance plan may have been unable to do so, the Internal Revenue Service has decided to allow dealers who want to enter into the compliance plan to do so until April 14, 1982. You may accept the compliance plan through a majority group, a minority group, or on an individual basis. To receive the compliance letter from the District Director, you must inform the Internal Revenue Service of your intention to comply as detailed below.
>
> * * *
>
> Individual Compliance System
>
> If you want to enter an individual compliance plan, send a letter stating your desire to comply to the Internal Revenue Service. The letter must be postmarked by midnight, April 14, 1982. Send the letter to:
>
> Internal Revenue Service
> Toke Project Group
> Caller Box 16045
> Las Vegas, NV 89101
>
> Include your name, address, social security number, the casino you work at and the game you deal. You will be required to do the following things in connection with an individual compliance plan:

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1. Maintain a monthly record of your tokes on a daily basis and submit that record to the Internal Revenue Service each month for 24 months.

2. Report all of your toke income to your employer each month as required by the Internal Revenue Code. You must report your toke income from January 1, 1982 forward.

When you receive your compliance letter from the District Director, you will receive more complete details about the requirements of the individual plan, as well as the forms to fill out.

The Internal Revenue Service will not audit your prior year tax returns for toke income as long as you report all your toke income from January 1, 1982 forward under an acceptable compliance plan. If you want to enter a compliance plan, you must contact the Internal Revenue Service as described above by April 14, 1982. If you decide not to enter into a compliance plan, your prior year tax returns will not be exempt from audit for toke income.

In March, 1982, petitioner indicated to respondent that she wished to participate in the program and received from respondent's acting district director a compliance letter which stated:

In consideration of 100 percent compliance with the employee "toke" reporting requirements of the Internal Revenue Code, the Internal Revenue Service agrees to refrain from initiating any form of examination activity for toke income against you for all open years prior to January 1, 1982, the effective date of this agreement. The term "all open years" includes all individual income tax returns upon which the statute of limitations has not yet expired. This "open year" period includes the period January 1, 1981, through December 31, 1981.

In consideration of the Internal Revenue Service not initiating any form of examination activity for toke income, you agree to comply fully with the toke reporting requirements of the Internal Revenue Code.

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The reporting of your toke income through an approved system indicates your acceptance of this agreement.

From April 1982 through September 1982 petitioner was on maternity leave and received no salary or toke income from Caesar's. Petitioner returned to Caesar's in October 1982 and was employed for the balance of 1982 and all of 1983. The parties have stipulated that she failed to report her toke income to Caesar's for December of 1982 and for January, March, June, and November of 1983. She also admits that all of her toke income for 1982 was not reported on the original joint tax return for that year.

In the administration of the toke program, respondent adopted the practice of permitting a dealer to amend his or her 1982 tax return if their toke income had not been fully reported on the original return, but only if they filed the amended return for 1982 prior to December 31, 1983. Petitioners, however, made no attempt to amend their original return until September 10, 1984, which was approximately two weeks after respondent had notified them by letter dated August 28, 1984 that their returns for 1980 and 1981 were being audited. In the audit of the 1980 and 1981 returns, respondent determined that petitioner's toke income had been underreported by $21,982 and $20,238, respectively.

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OPINION

Petitioner claims that with the filing of the amended return for 1982 she complied with all of the terms of respondent's program and, therefore, she should be relieved from her 1980 and 1981 tax liabilities. Respondent contends that petitioner failed to comply with either the letter or the intent of the agreement and that under the circumstances the amended return did not bring her into compliance with the program. Petitioner has the burden of proof. Welch v. Helvering, 290 U.S. 111 (1953), Rule 142(a).

Respondent's letters to petitioner clearly state that in order to comply with the program she would be required to:

(1) affirmatively accept the program by the deadline established for Caesar's;

(2) completely and accurately report to the Internal Revenue Service on a monthly basis all tokes received by her on or after January 1, 1982; and

(3) report all tokes received to Caesar's on a monthly basis as required by section 6053(a).

In addition to the above specific terms, respondent asserts that petitioner was also informed that under the program she was required to fully and accurately report all toke income on her

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tax returns. Petitioner's argument to the contrary on brief is contradicted by her testimony at trial.[3] In any event, the full and accurate reporting of taxable income is required of all taxpayers, whether or not covered by the compliance program.

Petitioner admits that she failed to report any toke income to Caesar's for five months and that such income was not fully reported on the initial joint return for 1982. She further admits that the amended joint return for 1982 containing all of her toke income was not filed until after she was informed of the impending audit for 1980 and 1981. It is apparent, therefore, that petitioner failed to comply with her obligations under the toke program.

Petitioner contends, however, that even if she failed to comply with the terms of the program respondent should be prohibited from auditing her pre-1982 returns because: (1) the program constituted an amnesty program under which she acquired certain rights which are not subject to forfeiture; (2) the audit would violate her constitutional right to due process; or (3) the audit would violate her constitutional right to the equal protection of the law.

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3 QUESTION: Under this compliance program, what do you understand your obligations to be? What were you supposed to do?

ANSWER: I was supposed to start declaring a hundred percent of my income to the IRS and pay taxes on it.

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First, petitioner insists that respondent's toke program amounted to an amnesty under which she acquired certain absolute rights that are not subject to forfeiture in the absence of clear and unequivocal language setting forth the conditions of forfeiture. Respondent, on the other hand, argues that his toke program was nothing more than administrative management of available resources. From our examination of the entire record, we can find no evidence which indicates that respondent ever presented the toke program as a tax amnesty. Furthermore, even if it were presented as a tax amnesty, we are satisfied that petitioner's obligations under the toke program were clearly and unequivocally stated as pre-conditions to respondent's obligations under the agreement.

Secondly, petitioner argues that respondent's failure to give her notice of his audit criteria for noncomplying dealers was in violation of her constitutional right to due process. In reply, respondent contends that he was under no duty to notify noncomplying dealers of the time within which they would be permitted to amend their returns, nor was he required to give noncomplying dealers a hearing to determine if they should be audited.

It is well settled that with exceptions we will not go behind a notice of deficiency to examine the motives, administrative policies, or procedures of respondent in making a determination. Proesel v. Commissioner, 73 T.C. 600, 605 (1979); Greenberg's Express, Inc. v. Commissioner, 62 T.C. 324, 327 (1974); Human

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Engineering Institute v. Commissioner, 61 T.C. 61, 66 (1973). The rationale for such conclusion being that a trial before this Court is a proceeding de novo and our determination must be based upon the merits of the case as presented here and not upon a record previously developed at the administrative level. Greenberg's Express, Inc. v. Commissioner, supra at 328. A recognized exception to this rule is that where there is substantial evidence of unconstitutional conduct on the part of respondent's agents the integrity of our judicial process would be impugned if we permitted respondent to benefit from the unconstitutional conduct. See Suarez v. Commissioner, 58 T.C. 792 (1972).

In this case, however, petitioner has failed to make a showing that her constitutional rights have been violated. Due process does not require respondent to use any particular method in selecting taxpayers for audit. The broad mandate to investigate and examine persons who may be liable for taxes vests in respondent the discretion to determine which taxpayers can and should be audited with the resources available to him. Greenberg's Express, Inc. v. Commissioner, supra at 328-329. Nor can we agree with petitioner's assertion that lack of written notice with respect to respondent's audit criteria denied her due process. The Constitution's due process requirements are satisfied where an "adequate opportunity is afforded for a later

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judicial determination of the legal rights" involved. Phillips v. Commissioner, 283 U.S. 589, 595 (1931). That requirement is satisfied by petitioner's right to a trial de novo in this Court.

Finally, petitioner argues that her constitutional right to the equal protection of the law has been violated because other noncomplying dealers were permitted by respondent to avoid audits for 1980 and 1981 by simply filing amended returns for 1982. Here again, it is the well-established position of this Court that our responsibility is to apply the law to the facts of the case before us and to determine the correct tax liability of the particular taxpayer or taxpayers involved. How the Commissioner may have treated other taxpayers has generally been considered irrelevant to our decision. See Davis v. Commissioner, 65 T.C. 1014, 1022 (1976), and the cases cited therein; see also Teichgraeber v. Commissioner, 64 T.C. 453 (1975). Furthermore, even the conscious exercise by respondent of some selectivity in enforcement is not in and of itself a constitutional violation of equal protection if the selection is not based on impermissible considerations such as race, religion, or other arbitrary classification. Oyler v. Boles, 368 U.S. 448 (1962).

Petitioner also argues that respondent's audit discriminated against her in particular. To prevail on this ground, petitioner must meet two requirements. First, she must demonstrate that, while others similarly situated have not been selected for audit even though engaged in conduct of the type forming the basis of the tax deficiencies against her, she was singled out for tax

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audit and a deficiency determination. Second, she must demonstrate that the Commissioner's discriminatory selection of her was based upon impermissible considerations such as race, religion, or the desire to prevent the exercise of her constitutional rights. United States v. Stout, 601 F.2d 325 (7th Cir. 1979); United States v. Kahl, 583 F.2d 1351 (5th Cir. 1978); United States v. Scott, 520 F.2d 697 (9th Cir. 1975); United States v. Swanson, 509 F.2d 1205 (8th Cir. 1975); United States v. Berrios, 501 F.2d 1207 (2d Cir. 1974); United States v. Malinowski, 472 F.2d 850 (3d Cir. 1973).

Respondent asserts, and petitioner has failed to present any evidence to the contrary, that only those dealers who amended their 1982 returns before the commencement after December 31, 1983 of audit proceedings for the years prior to 1982 were considered to be in compliance with the toke program. It was only those dealers, like petitioner, who failed to fully report by December 31, 1983, their 1982 toke income by amended return or otherwise, that were selected for audit in the prior years. Consequently, petitioner has failed to establish that she was not treated by respondent in the same manner as all other dealers in her position were treated by respondent. Therefore, her asserted constitutional right to the equal protection of the law was not denied.

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We conclude, therefore, that petitioner failed to comply with the terms of the toke compliance agreement, and respondent had no obligation to refrain from auditing the 1980 and 1981 joint tax returns.

To reflect the foregoing, as well as concessions made by the parties,

Decision will be entered under Rule 155.

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JU11.7/2:1986-437

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T. C. Memo. 1986-437

UNITED STATES TAX COURT

CHARLES CATANIA, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 20808-84. Filed September 15, 1986.

B. Mahlon Brown, for the petitioner.

Kenneth A. Burns, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: In a statutory notice dated April 5, 1984, respondent determined a deficiency in petitioner's income tax for 1980 in the amount of $5,684.19 and an addition to tax under section 6653(a)[1] in the amount of $284.21.[2]

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1 All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

2 The parties have stipulated that the deficiency for 1980 shall be $5,000.00 and the addition to tax $250.00 in the event this Court rules that petitioner is not relieved of his 1980 tax liability.

C.M./VL

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After concessions, the only issue remaining for decision is whether petitioner failed to comply with respondent's toke compliance program and, if so, whether the failure relieves respondent of his obligations to petitioner.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by reference.

Petitioner resided in Las Vegas, Nevada, at the time he filed his petition. His income tax return for 1980 was filed with the Internal Revenue Service Center at Ogden, Utah. Petitioner admits that on the return for 1980 he did not report ail of the toke income he received during the year as a twenty-one dealer at Caesar's Palace (Caesar's).

During 1981, respondent instituted in Nevada a toke compliance program in an attempt to stop a tax loss estimated to be in excess of $100,000,000 per year from the failure of casino dealers to fully and accurately report their toke income. The program was designed to conserve respondent's Nevada audit resources while achieving an increase in the compliance by the dealers with the tip reporting requirements of the Internal Revenue Code. In general terms, under the discretionary program, the Service agreed not to audit a dealer's pre-1982 returns if the dealer fully participated in the program.

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On October 15, 1981, the local examination group manager for respondent sent a letter to all of Caesar's dealers, including petitioner, informing them of the toke compliance program. The pertinent provisions of the letter are set out below:

> In September of this year, Internal Revenue Service initiated a payroll tax audit of your employer's tax return. Your employer was required by law to provide the information requested in connection with this payroll tax audit. As in any normal audit, the procedures included a review of the payroll records of all employees including dealers. It is the intention of the Service to use information gathered not only for a determination of the correct payroll tax of your employer, but also for the conduct of a dealers' toke project.
>
> In the alternative, the Internal Revenue Service is willing to enter into an agreement with Caesar's Palace Dealers whereby current compliance with the tax laws can be achieved without conducting a toke project. You will not be audited if you agree to begin currently reporting 100 percent of your tokes under an acceptable plan. Examples of acceptable plans are as follows:
>
> * * *
>
> PLAN FOR DEALERS WHO DO NOT POOL TOKES, SUCH AS POKER AND CRAPS DEALERS OR DEALERS WHO POOL VOTE NOT TO ADOPT A REPORTING SYSTEM FOR THE GROUP:
>
> > You would be allowed to report your tips individually. The individual method requires the reporting of toke income on a monthly basis to the IRS. The law requires that if you make more than $20 per month in tokes that you report them to your employer by the 10th of the following month. If you would be uneasy about reporting your tokes to your employer because of peer pressure, you may report to us and make quarterly estimated tax payments. If you do not pool tokes or the dealers in your casino do not accept a group reporting system by the compliance date, contact the IRS at 385-6362 if you want to comply.

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> Upon notice to the IRS of your participation in either method of current compliance, you will receive a letter from the District Director stating that in return for current compliance, the Internal Revenue Service will not start an audit of your tax return for toke income for 1978, 1979, 1980 or 1981 from January 1, 1981 through the date when 100 percent reporting starts.
>
> The tax savings are significant. The estimated average deficiency and penalties for any given year are over $5,000.000 [sic] per year. If current compliance is not achieved, the Internal Revenue Service will be forced to pursue an information gathering project to determine toke income for past and current years.
>
> * * *
>
> We will be holding meetings for the dealers from your hotels to discuss this proposal. You may attend whichever meeting is more convenient for you. If you have any questions, you may ask them at the meeting or call us at 385-6362.
>
> Our primary goal is current compliance.

Subsequently, Caesar's dealers received a second letter from respondent's acting group manager which stated in pertinent part as follows:

> You were among the dealers at several hotels contacted by the Internal Revenue Service in 1981 regarding the dealer toke compliance plan. The deadline to enter into the plan on an individual basis was December 10, 1981. Many dealers have informed the Internal Revenue Service that there was confusion among the dealers because they had received conflicting information and therefore, they did not realize that December 10th was the last day they could enter into the compliance plan on an individual basis. Although group compliance systems could be instituted after December 10th, many dealers have informed us that they could not get a majority of dealers organized to start a group system.
>
> Since many dealers who may have wanted to enter the compliance plan may have been unable to do so, the Internal Revenue Service has decided to allow dealers who want to enter into the compliance plan to do so until April 14, 1982. You may accept the compliance plan through a majority group, a minority group, or on

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an individual basis. To receive the compliance letter from the District Director, you must inform the Internal Revenue Service of your intention to comply as detailed below.

* * *

Individual Compliance System

If you want to enter an individual compliance plan, send a letter stating your desire to comply to the Internal Revenue Service. The letter must be postmarked by midnight, April 14, 1982. Send the letter to:

Internal Revenue Service
Toke Project Group
Caller Box 16045
Las Vegas, NV 89101

Include your name, address, social security number, the casino you work at and the game you deal. You will be required to do the following things in connection with an individual compliance plan:

1. Maintain a monthly record of your tokes on a daily basis and submit that record to the Internal Revenue Service each month for 24 months.

2. Report all of your toke income to your employer each month as required by the Internal Revenue Code. You must report your toke income from January 1, 1982 forward.

When you receive your compliance letter from the District Director, you will receive more complete details about the requirements of the individual plan, as well as the forms to fill out.

The Internal Revenue Service will not audit your prior year tax returns for toke income as long as you report all your toke income from January 1, 1982 forward under an acceptable compliance plan. If you want to enter a compliance plan, you must contact the Internal Revenue Service as described above by April 14, 1982. If you decide not to enter into a compliance plan, your prior year tax returns will not be exempt from audit for toke income.

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After petitioner had indicated to respondent by telephone that he wished to participate in the program, he received from respondent's district director a compliance letter which stated:

> In consideration of 100 percent compliance with the employee "toke" reporting requirements of the Internal Revenue Code, the Internal Revenue Service agrees to refrain from initiating any form of examination activity for toke income against you for all open years prior to January 1, 1982, the effective date of this agreement. The term "all open years" includes all individual income tax returns upon which the statute of limitations has not yet expired. This "open year" period includes the period January 1, 1981, through December 31, 1981.
>
> In consideration of the Internal Revenue Service not initiating any form of examination activity for toke income, you agree to comply fully with the toke reporting requirements of the Internal Revenue Code.
>
> The reporting of your toke income through an approved system indicates your acceptance of this agreement.

The compliance letter received by petitioner from respondent's district director was not accompanied by the forms, or calendars, on which petitioner was expected to make the monthly reports of his toke income to respondent; and even though he made at least one request for such forms before the end of 1981, he never received the forms. As a result, he did not make any monthly reports to respondent. However, from January through May of 1982 he fully and accurately reported all of his toke income to Caesar's but made no such reports after May of 1982.

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On April 13, 1984, petitioner filed a 1982 income tax return which contained all of his toke income for that year. On the same date he filed a return for 1983 which contained all of his toke income for that year.

In the administration of the toke program, the 1982 reports and returns of dealers who failed to comply with one or more of the program requirements were examined by respondent's agents on a case by case basis in order to determine whether their compliance was sufficient to forego an audit of their returns for prior years. In these determinations, minor deviations by dealers in making monthly reports to their casinos or to respondent were ignored by respondent's agents. In the administration of the program, respondent also adopted the practice of permitting a dealer to amend his or her 1982 tax return if their toke income had not been fully reported on the original return, but only if they filed the amended return for 1982 prior to December 31, 1983. However, petitioner and other non-complying dealers were not advised of these practices and petitioner made no attempt to file his original return until April 13, 1984, which was approximately a week after respondent had mailed the notice of deficiency on April 5, 1984. In the notice, respondent determined that petitioner's toke income for 1980 had been underreported by $17,843.75.

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OPINION

Petitioner claims that with the filing of the return for 1982 which contained all of his toke income he complied with respondent's program and, therefore, he should be relieved from his 1980 tax liabilities. Respondent contends that petitioner failed to comply with either the letter or the intent of the agreement and that the delinquent filing of the 1982 return did not bring him into compliance with the program. Petitioner has the burden of proof. Welch v. Helvering, 290 U.S. 111 (1953), Rule 142(a).

Respondent's letters to Caesar's dealers clearly state that in order to comply with the program each dealer would be required to:

(1) affirmatively accept the program by the deadline established for Caesar's;

(2) completely and accurately report to the Internal Revenue Service on a monthly basis all tokes received by him on or after January 1, 1982; and

(3) report all tokes received to Caesar's on a monthly basis as required by section 6053(a).

In addition to the above specific terms, respondent asserts that petitioner was also informed that under the program he was required to fully and accurately report all toke income on his tax returns. Petitioner's argument to the contrary is

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contradicted by the testimony of other dealers. In any event, the full and accurate reporting of taxable income is required of all taxpayers, whether or not covered by the compliance program.

Petitioner admits that he failed to report any toke income to Caesar's for seven months in 1982 and that he made no monthly reports of such income to respondent. He further admits that the return for 1982 containing all of his toke income was not filed until after he had received the deficiency notice for 1980. It is apparent, therefore, that even if we overlook his failure to make monthly reports to respondent because he was not furnished with the necessary forms, petitioner still failed to comply with substantially all of his obligations under the toke program.

Petitioner contends, however, that even if he failed to comply with the terms of the program respondent should be prohibited from auditing his pre-1982 returns. First, petitioner insists that respondent's toke program amounted to an amnesty under which he acquired certain absolute rights that are not subject to forfeiture in the absence of clear and unequivocal language setting forth the conditions of forfeiture. Respondent, on the other hand, argues that his toke program was nothing more than administrative management of available resources. From our examination of the entire record we can find no evidence which indicates that respondent ever presented the toke program as a tax amnesty. Furthermore, even if it were presented as a tax

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amnesty, we are satisfied that petitioner's obligations under the toke program were clearly and unequivocally stated as preconditions to respondent's obligations under the agreement.

Secondly, petitioner argues that respondent's failure to give him notice of his audit criteria for noncomplying dealers was in violation of his constitutional right to due process. In reply, respondent contends that he was under no duty to notify noncomplying dealers of the time within which they would be permitted to file correct returns, nor was he required to give noncomplying dealers a hearing to determine if they should be audited.

It is well settled that with exceptions we will not go behind a notice of deficiency to examine the motives, administrative policies, or procedures of respondent in making a determination. Proesel v. Commissioner, 73 T.C. 600, 605 (1979); Greenberg's Express, Inc. v. Commissioner, 62 T.C. 324, 327 (1974); Human Engineering Institute v. Commissioner, 61 T.C. 61, 66 (1973). The rationale for such conclusion being that a trial before this Court is a proceeding de novo and our determination must be based upon the merits of the case as presented here and not upon a record previously developed at the administrative level. Greenberg's Express, Inc. v. Commissioner, supra at 328. A recognized exception to this rule is that where there is substantial evidence of unconstitutional conduct on the part of respondent's

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agents the integrity of our judicial process would be impugned if we permitted respondent to benefit from the unconstitutional conduct. See Suarez v. Commissioner, 58 T.C. 792 (1972).

In this case, however, petitioner has failed to make a showing that his constitutional rights have been violated. Due process does not require respondent to use any particular method in selecting taxpayers for audit. The broad mandate to investigate and examine persons who may be liable for taxes vests in respondent the discretion to determine which taxpayers can and should be audited with the resources available to respondent. Greenberg's Express, Inc. v. Commissioner, supra at 328-329. Nor can we agree with petitioner's assertion that lack of written notice with respect to respondent's audit criteria denied him due process. The Constitution's due process requirements are satisfied where an "adequate opportunity is afforded for a later judicial determination of the legal rights" involved. Phillips v. Commissioner, 283 U.S. 589, 595 (1931). That requirement is satisfied by petitioner's right to a trial in this Court.

Finally, petitioner argues that his constitutional right to the equal protection of the law has been violated because other noncomplying dealers were permitted by respondent to avoid audits for 1980 and 1981 by simply filing amended returns for 1982. Here again, it is the well-established position of this Court that our responsibility is to apply the law to the facts of the case before us and to determine the correct tax liability of the particular taxpayer or taxpayers involved. How the Commissioner

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may have treated other taxpayers has generally been considered irrelevant to our decision. See Davis v. Commissioner, 65 T.C. 1014, 1022 (1976), and the cases cited therein; see also Teichgraeber v. Commissioner, 64 T.C. 453 (1975). Furthermore, even the conscious exercise by respondent of some selectivity in enforcement is not in and of itself a constitutional violation of equal protection if the selection is not based on impermissible considerations such as race, religion, or other arbitrary classification. Oyler v. Boles, 368 U.S. 448 (1962).

Petitioner also argues that respondent's audit discriminated against him in particular. To prevail on this ground, petitioner must meet two requirements. First, he must demonstrate that, while others similarly situated have not been selected for audit even though engaged in conduct of the type forming the basis of the tax deficiencies against him, he was singled out for tax audit and a deficiency determination. Second, he must demonstrate that the Commissioner's discriminatory selection of him was based upon impermissible considerations such as race, religion, or the desire to prevent his exercise of constitutional rights. United States v. Stout, 601 F.2d 325 (7th Cir. 1979); United States v. Kahl, 583 F.2d 1351 (5th Cir. 1978); United States v. Scott, 520 F.2d 697 (9th Cir. 1975); United States v. Swanson, 509 F.2d 1205 (8th Cir. 1975); United States v. Berrios, 501 F.2d 1207 (2d Cir. 1974); United States v. Malinowski, 472 F.2d 850 (3d Cir. 1973).

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Respondent asserts, and petitioner has failed to present any evidence to the contrary, that only those dealers who filed correct original or amended 1982 returns before the commencement after December 31, 1983 of audit proceedings for the years prior to 1982 were considered to be in compliance with the toke program. It was only those dealers, like petitioner, who failed to fully report by December 31, 1983, their 1982 toke income by a correct original or amended return, that were selected for audit in the prior years. Consequently, petitioner has failed to establish that he was not treated by respondent in the same manner as all other dealers in his position were treated by respondent. Therefore, his asserted constitutional right to the equal protection of the law was not denied.

We conclude, therefore, that petitioner failed to comply with the terms of the toke compliance agreement, and respondent had no obligation to refrain from auditing the 1980 tax return.

To reflect the foregoing, as well as concessions made by the parties,

Decision will be entered under Rule 155.

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T. C. Memo. 1986-438

UNITED STATES TAX COURT

JOHN A. NARD, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 25263-81. Filed September 15, 1986.

John W. Giltinan, for the petitioner.

Russell F. Kurdys, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: In a notice of deficiency mailed to petitioner on July 8, 1981, respondent determined a deficiency in petitioner's income tax for 1968 in the amount of $201,985.09 and an addition to tax under section 6653(b)[1] in the amount of

[1] All section references are to the Internal Revenue Code of 1954, as amended, during the year in issue unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

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$119,727.87. In the statutory notice respondent asserted that the deficiency was caused by petitioner's failure to report on his 1968 return the following items of income:

(1) $364,150.66 in materials and labor charged by petitioner to Armour and Company and used by him in the construction of a personal residence on certain lots located in Sewickley Heights Estates;

(2) $20,000 in commissions received by petitioner for services rendered to the developer of Sewickley Heights Estates, the commissions being paid by the transfer during the year to petitioner of the lots on which the above residence was constructed; and

(3) $16,000 in salary received by petitioner from Three Rivers Company.

At trial, respondent conceded that the $16,000 in salary had been reported by petitioner on the 1968 return. On brief, respondent also waived any increased deficiency which is attributable to the omission from petitioner's return of a finder's fee in the amount of $4,000 received from Louis Countouris. Respondent, however, did not waive the right to use this omission as part of his proof of fraud.

With the above concessions, the issues remaining for decision are (1) whether petitioner realized income from the construction of the personal residence and the receipt of the lots upon which it is built; and (2) whether petitioner is liable under section 6653(b) for the addition to tax for fraud.

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FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation, supplemental stipulation, and exhibits attached thereto are incorporated herein by reference.

Petitioner, John A. Nard, who also uses the name of J. A. Nard, resided in Sewickley, Pennsylvania, at the time his petition was filed.

Petitioner was born in Norton, Virginia in 1928. He attended Virginia Military Institute for about a year and subsequently received in 1951 a degree in engineering from the University of Pittsburgh. He has been married to Kathleen O. Nard since 1952. They have five children. Petitioner also has a brother who is known as A. J. Nard.

With money borrowed from his family, petitioner started the J. A. Nard Oldsmobile Company in 1952. The company was not successful and failed completely in 1957 leaving petitioner indebted to his partner for approximately $15,000. This debt was repaid by petitioner in 1963 with funds received from the sale of a house.

During 1957 and 1958 petitioner sold cars for McKean Oldsmobile Company and received Forms W-2 reflecting taxable wages in the respective amounts of $7,908.08 and $4,315.85. A subsequent investigation by respondent's agents revealed that petitioner did not file income tax returns for 1957 and 1958.

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However, the investigation also revealed that in those years he had overpayments in the respective amounts of $116.74 and $340.90.

During the years 1959 through 1963 petitioner sold material handling equipment for Albert Curry Company and received Forms W-2 reflecting the following wages and withholding tax:

Taxable Year	Wages	Withholding Tax
1959	$ 11,330.00	$ 1,441.80
1960	19,176.00	2,311.68
1961	14,692.00	1,776.00
1962	15,603.00	1,920.00
1963	9,615.25	1,273.90

Subsequent investigation by respondent's agents revealed that for these years petitioner did not file income tax returns, and on March 1, 1966, the matter was referred to the Intelligence Division of the Internal Revenue Service by Revenue Agent John S. Warwick with the request that the case be investigated because respondent's records indicated that petitioner had not filed income tax returns for the years 1940 through 1964. In the Intelligence Division the matter was assigned to Special Agent John J. Kish whose investigation covered the years 1960 through 1963 and culminated in a report dated July 20, 1966 in which Special Agent Kish stated:

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The following is a computation at joint rates of the additional income tax due for the years 1960 through 1963:

Year	Total Tax	Less: W-2 Withholding Tax	Additional Tax Due
1960	$3,492.80	$2,311.68	$1,181.12
1961	2,223.92	1,776.00	447.92
1962	2,460.78	1,920.00	504.78
1963	899.90	1,273.90	(374.00)

CONCLUSIONS AND RECOMMENDATIONS

Although the investigation disclosed that Nard had failed to filed personal income tax returns for the years under investigation, it is concluded that this case does not possess the minimum standards necessary for criminal prosecution for the following reasons:

1. Additional income tax is de minimis for the years 1960 to 1962, and in 1963 a refund is due the taxpayer.

2. Unreported income consisted solely of wages subject to withholding tax, no additional sources of income were disclosed.

3. There are no indications of any net worth increases.

Based on the foregoing, it is recommended that the preliminary investigation be closed without further action by the Intelligence Division at this time.

The matter was returned to the Audit Division of respondent's Pittsburgh office where it was ultimately determined that there were no deficiencies with respect to the years 1957, 1958, 1959, and 1964. It was also concluded that petitioner "probably had little or no taxable income prior to 1957" since his involvement in the Oldsmobile dealership resulted in bankruptcy.

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In September of 1963, petitioner left the Albert Curry Company and helped organize a Pennsylvania partnership known as the Three Rivers Company (Three Rivers) for the purpose of constructing and operating a cold storage warehouse at 295 West Steuben Street, Pittsburgh. The construction of the warehouse was completed in 1965.

Until it was dissolved in 1974, the partnership interests in Three Rivers were held as follows:

Partner	Percentage
John A. Nard	35
R. Stewart Scott	35
Porter H. Scott	15
Walter A. Scott, Jr.	15

The Scotts are brothers who during the years under consideration owned and operated in a separate partnership a family real estate business known as Scott & McCune. For all practical purposes, petitioner and R. Stewart Scott (Stewart) were the only active partners in Three Rivers. Petitioner was in charge of its day to day construction activities, while Stewart took care of its financial arrangements. Petitioner did not receive a salary from Three Rivers during 1963 and 1964, but was advanced funds by the partnership for living expenses. Beginning in 1965 he received a salary.

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The Armour Project

In August of 1967, Three Rivers entered into a contact to design and build[2] a meat processing plant for Armour and Company near Three Rivers' cold storage facility on Steuben Street. The Armour contract, as negotiated by petitioner and Stewart, provided for a total contract price of $6,440,000, including an anticipated profit of $1,500,000 for Three Rivers. The contract required a retainage which was later fixed at 15 percent.

Petitioner was responsible for the actual construction of the plant. At first he caused Three Rivers to act as its own general contractor and to employ separate subcontractors for each phase of the work. Subsequently, he arranged to have McCully-Smith, Inc., a general contracting firm, which was originally engaged to do only the concrete work on the plant, to supervise the work of some other subcontractors and to accumulate and submit their invoices to Three Rivers. As a result, part of the subcontractors submitted their invoices for materials and labor directly to Three Rivers and were paid accordingly. These subcontractors included Dodson Engineering, Penn Plumbing and Lendoll Corporation. Other subcontractors submitted their invoices through McCully-Smith and were paid by McCully-Smith.

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2 As found by the District Court in subsequent litigation, Armour and Three Rivers contemplated that the plant would be designed and built simultaneously and the parties were aware that such procedure would require a substantial amount of "extra work" which was not included in the original agreement.

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James E. McCully (McCully), petitioner's brother-in-law, owned 50 percent of the stock in McCully-Smith and was the chairman of its board of directors. In October of 1967, he caused petitioner to be named a director of the company. Petitioner served without pay as a director until May of 1970 when he was removed by McCully because of the litigation which had developed between McCully-Smith and Three Rivers. Petitioner was never an officer or stockholder of McCully-Smith.

Stewart was primarily responsible for the accounting and the financing of the Armour project. To do the accounting, he employed Clifford Collins (Collins) to work part time for Three Rivers. Collins was already working full time as general manager for Scott & McCune and he continued in this capacity. Scott & McCune's office, in which Collins worked, was located in the Frick Building.

To account for the work being done, Stewart and Collins established a McBee recordkeeping system. Under this system, Collins accumulated the invoices from the subcontractors, classified and posted them according to account number, determined the amount to be paid on each, prepared the necessary checks, took the checks to Pittsburgh National Bank (PNB) to obtain a draw to cover the checks, and then issued the checks to the payees. Account numbers were established according to specific work categories such as steel, plumbing, grading, and the like. All of Three Rivers checks had to be signed by at least two partners. Most of the time they were signed by

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petitioner and Stewart. If Collins had any questions regarding which account number was to be used for an invoice, such questions were resolved by petitioner.

In order to provide funds for the construction of the Armour plant, a disbursement procedure was agreed to by Three Rivers, Armour, and PNB. Under this procedure, Three Rivers would prepare an invoice on which the value of work performed to date was estimated. The invoice, signed by petitioner, was then submitted for approval to three Armour employees, the field engineer, the field accountant, and the project manager, D. E. Zaremba, all of whom were located at the site of the project. Upon approval of the invoice in the above manner, a progress payment certificate was issued to PNB by Zaremba for the amount of the invoice, less the agreed retainage. Upon receipt of the certificate, the net amount was released by PNB to Three Rivers and charged to Armour.

Collins was responsible for keeping a record for Three Rivers of the amounts certified to PNB by Armour as well as the amounts paid out by PNB pursuant to such certifications.

Each month, McCully-Smith would mail or hand deliver its package of invoices to Three Rivers. The package usually consisted of a summary sheet with attached supporting data for each of McCully-Smith's subcontractors. At the beginning these packages were delivered to Three Rivers at the construction site on Steuben Street. Later the packages were delivered to Collins at the Frick Building which was located eight to ten miles from

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the construction site. When the packages were delivered to the construction site they were transported from there to the Frick Building by petitioner, usually on a daily basis. Upon receipt of a package of invoices Collins would break down each invoice and charge the items to specific accounts. In due course, Collins would eventually pay McCully-Smith who in turn would pay its subcontractors.

As construction progressed, major changes occurred in the original plans. To compensate for each change an extra work order (E.W.A.) was issued. The extra work orders were considered additions to the original contract. To account for such changes, McCully-Smith included its E.W.A.'s in the invoice packages delivered to Three Rivers.

The Nard Residence

In October or November of 1967 petitioner started construction of a personal residence in Sewickley. The construction on the house continued until November of 1968. On December 4, 1967, petitioner employed Elso J. Baggio (Baggio), to supervise the construction of the residence for a total fee of $14,000 which was to be paid at the rate of $2,000 per month. Baggio was told by petitioner to submit all bills for labor and materials on the house to McCully-Smith. To account for the invoices being received on the house, Mr. McCully, at McCully-Smith, set up a separate E.W.A. to the Armour project. This

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account was titled E.W.A. 40 and all invoices charged to it were billed by McCully-Smith to Three Rivers as additional work on the Armour contract.

During the construction of petitioner's residence Baggio independently hired some workers who had been or were concurrently working on the Armour project. In addition, petitioner hired some subcontactors for work on the house who had done work at the Armour plant. All workers and subcontractors on the house were told by petitioner to bill either McCully-Smith or Three Rivers for work done on the house. Among the subcontractors who worked at one time or another on the house were Roofing, Inc., Dodson Engineering, Schmertz & Erwin, Lendoll Corporation, McCully-Smith, Penn Plumbing, Frank Dyson, Inc., W. T. Morton, R. C. Lame Associates, James Valiant Company, and Hornfield Engineering.

At the end of 1967 and during the early part of 1968, Stewart was involved in remodeling and improving his residence. The work was quite extensive and included a deck and a swimming pool. McCully-Smith supervised the work, charged all invoices for material and labor to E.W.A. 40 and ultimately billed them to Three Rivers as extra work on the Armour contract. Although Three Rivers' records did not disclose that invoices for the work being done on the houses of petitioner and Stewart were being charged to the Armour contract, such invoices were identified and segregated on the records of McCully-Smith.

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Stewart eventually paid or otherwise satisfied Three Rivers with respect to the work done on his house. As of the date of trial petitioner had not paid anyone for any part of the labor and materials determined by respondent to have been used in his house.[3] When asked about payment during the construction in 1967 and 1968, petitioner repeatedly told McCully, Baggio, and several other subcontractors and workers that everyone would be paid when he collected his 35 percent of the profit in the Armour contract. At trial Stewart and both of his brothers admitted that prior to the end of 1968 they were aware that work on petitioner's house had been charged to Three Rivers and hence to Armour.

During the summer of 1968 as construction on the Armour plant progressed toward completion,[4] relations between petitioner and the subcontractors as well as between petitioner and Armour began to deteriorate. Part of the difficulty stemmed from the fact that in September of 1968 petitioner was employed by Armour to take charge of the construction of a second plant in Sioux City, Iowa. With petitioner having two major construction projects separated by about 1,000 miles and the construction of a substantial house under way at the same time, the deterioration of the relations between petitioner and Armour accelerated.

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3 See pages 19-20, infra.

4 Ironically, the District Court found that in spite of the circumstances and haphazard fashion in which it was being done, the Armour project was 80 to 85 percent completed by November of 1968 and for the most part represented relatively good work.

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On November 21, 1968 Armour terminated the contract with Three Rivers for the plant construction in Pittsburgh and ceased all payments to Three Rivers and its subcontractors. Immediately thereafter, Armour filed a suit in the United States District Court for the Western District of Pennsylvania against Three Rivers and its four partners for breach of contract. In the suit, Armour alleged that funds had been diverted from its plant project and used to construct petitioner's residence and to make improvements to Stewart's house. A countersuit was filed by Three Rivers and its partners alleging breach of contract by Armour.

Over the next seven years, numerous suits and countersuits were filed by the parties as a result of the contract termination, but the original lawsuit was eventually tried, and on May 10, 1972, a judgment was entered by the District Court.[5] In the judgment, Three Rivers and its partners were ordered to make restitution to Armour for the following items:

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5 See Armour and Company v. Scott, et al., 360 F.Supp. 319 (W.D.Pa. 1972). The judgment was later affirmed by the Third Circuit. See Armour and Company v. Scott, 480 F.2d 611 (3d Cir. 1973).

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$395,101	The amount received by Three Rivers in excess of payments to subcontractors
176,900	Payments made on E.W.A. 40 for Nard
29,000	Payments made on E.W.A. 40 for Stewart Scott
36,000	Lendoll Corp.--brick work on the Nard residence
33,213	Penn Plumbing-- work on the Nard residence
$670,214	

To secure the payment of the amounts due as a result of work done on petitioner's house, the District Court impressed petitioner's property with a constructive trust in favor of Armour.

Petitioner did not pay any part of the judgment in favor of Armour, but Three Rivers eventually paid the total amount of the restitution[6] and amended its 1968 partnership return to reflect the payment. Petitioner's allocations on the amended return which was filed in December of 1973 reflected withdrawals of $291,653.73 and an ordinary loss of $135,450.49. His capital account as of the end of 1968 was determined to be a negative $454,791.76.

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6 After making the payment, Three Rivers and the Scott brothers attempted without success to obtain an assignment of the constructive trust on petitioner's house.

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Between 1968 and the date of trial, numerous judgments were entered against petitioner for labor and materials used in the construction of the house. These judgments included two in favor of McCully-Smith against petitioner and his wife for approximately $300,000.

Petitioner's 1968 Return

At or about the time the Armour litigation was being initiated, Revenue Agent William Sepesy (Sepesy) undertook an audit of the 1966, 1967 and 1968 partnership returns of Three Rivers. He ascertained that the original 1968 partnership return had been prepared by James A. Gray (Gray), the certified public accountant who was then serving the partnership and who was also the representative of the Scott brothers. The return had been prepared in the spring of 1969 following a meeting between Gray, Nard, and the Scott brothers during which the construction of petitioner's house and the manner in which the construction costs were charged had been discussed. In the preparation of the 1968 partnership return, Gray reported as income all amounts remitted to Three Rivers by Armour and deducted as expenses all checks issued by Three Rivers.

During his audit of the partnership returns, Sepesy met with petitioner and Gray. At this meeting, petitioner admitted that he had not filed income tax returns for 1967 and 1968, but during the meeting he agreed to have Mr. Gray prepare such returns immediately. In the continuing audit of Three Rivers' returns,

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Sepesy proposed to disallow as deductions certain payments made by the partnership to petitioner in 1968. During the negotiations which followed, Gray proposed that instead of disallowing the payments as partnership deductions that Sepesy treat the items as income to petitioner. Gray's primary concern at this point was to protect the Scotts and to close out the partnership audit. Sepesy agreed with the proposal and Gray then met with petitioner in an attempt to persuade him to pick up the disputed items as additional income. Petitioner indicated that he would go along with the proposal. Between July and September of 1969, Gray prepared petitioner's 1968 return. In the preparation of the return, Gray used partnership records, Sepesy's workpapers, and other figures provided by Sepesy. For the most part, petitioner's return was prepared from figures given to Gray by Sepesy. No part of the construction cost of petitioner's residence was included in the return. It was filed by petitioner as a married individual filing separately on the recommendation of Gray.

During this same period, July through September of 1969, Sepesy was preparing a referral report to the Intelligence Division. The report, dated September 4, 1969, stated that as of that date income tax returns had not been filed by petitioner for 1967 and 1968. The report was approved by the Chief of the Audit Division on September 5, 1969, and on that day, Sepesy was advised by Gray that the returns were ready to be filed. Later on September 5, 1969, Gray met with Sepesy and filed petitioner's

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1967 return[7] which reflected a tax liability of $2,582.51. He advised Sepesy that while the 1968 tax return had been prepared, it was not being filed at that time because petitioner was in the midst of the Armour litigation and did not have access at that time to all of his expense records. Nevertheless, Sepesy's referral report was forwarded unchanged to the Intelligence Division and the case was assigned to Special Agent Joseph Lawlor.

On November 19, 1969, Lawlor and Sepesy interviewed petitioner in the Special Agent's office. Petitioner was not represented. During the interview the agents repeatedly insisted that petitioner had not filed returns for both 1967 and 1968. Petitioner repeatedly stated that he thought Gray was handling the returns and that perhaps the 1968 return was not completed because his expenses could not be accurately calculated due to the pending lawsuit. The agents continued to insist that both the 1967 and 1968 returns had not been filed even though two months earlier Sepesy had personally accepted petitioner's 1967 return and knew that Gray had prepared the 1968 return using for the most part Sepesy's own figures. Petitioner's only explanation with respect to the 1967 return was that it must have been lost by the Internal Revenue Service. During the meeting petitioner admitted that McCully-Smith billed the costs of his

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7 At the same time Gray also filed with Sepesy petitioner's 1964 return which reported zero tax liability. Petitioner had delinquently filed returns for 1965 and 1966 in the fall of 1968 on which refunds were due in the respective amounts of $763 and $1,705.

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house to Three Rivers, but insisted that the house bills were never paid and that Gray was to charge him with income if and when the bills were paid.

On December 15, 1969, petitioner's 1968 tax return was filed and the case was reassigned from Special Agent Lawlor to Special Agent William McMahon.

During a meeting on October 18, 1971, petitioner told McMahon that before the end of 1968 he had talked with agent Jack Burke concerning the proper treatment of the house and that Burke suggested that petitioner keep a separate cost sheet on the house and pay taxes on the cost at the end of the year.

At the conclusion of his investigation Special Agent McMahon recommended that petitioner be prosecuted under section 7203 for willfully failing to timely file income tax returns for 1967 and 1968. The Special Agent did not recommend prosecution under section 7201 for willfully attempting to evade and defeat the payment of income tax for 1968.

On July 26, 1973, petitioner was indicted in the Western District of Pennsylvania under section 7203 for willfully failing to file income tax returns for 1967 and 1968. He was also indicted at the same time for willfully attempting to evade and defeat payment of his income tax for 1968. In February of 1974, petitioner pleaded guilty to both counts of failing to file and pleaded nolo contendere as to the evasion count for 1968.

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Commissions

In 1968 petitioner received certain lots on which his residence was being constructed from the developer of Sewickley Heights Estates. The lots which had a fair market value in 1968 of $20,000 were transferred to him in exchange for an equal amount of services which he acquired for the developer from Penn Plumbing and Pennsylvania Light & Power Company and for which petitioner was still liable at the time of the trial. The lots were not reported as income on his 1968 return.

Finder's Fee

In September 1968 petitioner received a finder's fee in the amount of $4,000 from Louis Countouris, an architect who performed professional services for Three Rivers. The fee was not reported on petitioner's 1968 return.

In his notice of deficiency, respondent determined that in 1968, petitioner had failed to report income totaling $364,150.66 for material and labor used in the construction of his house. The suppliers of such labor and materials and the amounts furnished by each was determined to be as follows:

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VENDOR	AMOUNT
Roofing, Inc.	$ 25,000.00
Dodson Engineering	3,138.89
Schmertz & Erwin A/C #91	2,300.00
Schmertz & Erwin A/C #203	2,500.00
Lendoll Corp. (Bricks)	38,179.24
McCully-Smith	254,943.22
Penn Plumbing	27,392.68
Frank Bryan, Inc.	5,000.00
W. P. Morton	206.70
R. C. Lame Associates	1,409.93
James Valiant Company	1,915.00
Hornfield Engineering	2,165.00
TOTAL	$364,150.66

Insofar as applicable here, respondent also determined that in 1968 petitioner had received and failed to report income in the form of lots having a fair market value of $20,000 from the developer of Sewickley Heights Estates and that petitioner was liable for the addition to tax provided by section 6653(b).

Petitioner does not deny that materials and labor in the amounts determined by respondent were used in 1968 in the construction of his residence. He contends, however, that such amounts do not constitute income because he intended to repay the same from his part of the profit under the Armour contract. He further contends in effect that he has realized no economic benefit from such amounts because when he was unable to collect his part of the profit in the Armour contract he was unable to pay the amounts and is still indebted for them either to McCully-Smith, other subcontractors or to Three Rivers.

Petitioner denies that he realized any income in 1968 upon receipt of the lots or the $4,000 from Louis Countouris.

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OPINION

Section 61(a) provides that gross income includes all income from whatever source derived. It is well settled that the broad sweep of "gross income" as used in section 61(a) includes wrongful appropriations by a taxpayer where he "acquires earnings lawfully or unlawfully, without the consensual recognition, expressed or implied, of an obligation to repay." James v. United States, 366 U.S. 213, 219 (1961); Rutkin v. United States, 343 U.S. 130 (1952); Davis v. United States, 226 F.2d 331 (6th Cir. 1955); and Leaf v. Commissioner, 33 T.C. 1093 (1960), affd. 295 F.2d 503 (6th Cir. 1961).

The factual situation before us differs from the factual situations involved in the above cases but factually our case is almost identical to that considered in Benes v. Commissioner, 42 T.C. 358, 378-379 (1964), affd. 355 F.2d 929 (6th Cir. 1966), cert. denied 384 U.S. 961 (1966). In Benes, we pointed out the same factual differences and set forth the tests to be applied in this type of situation in the following manner:

> The Davis and Leaf cases involved factual situations where the stockholder had diverted (Davis) or withdrawn (Leaf) cash funds from the corporation which he controlled. Both cases rely strongly on Rutkin v. United States, 343 U.S. 130, where the taxpayer who had extorted money from a victim, sought to avoid a conviction for tax evasion on the ground that he had no right or title to the extorted funds, but was under an obligation to return them to the payor-victim. Consequently, the defendant argued that the extorted funds were not taxable to him. The Supreme Court, sustaining the conviction, held that the extorted funds were taxable income, saying in part:

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> An unlawful gain, as well as a lawful one, constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it. * * * That occurs when cash, as here, is delivered by its owner to the taxpayer in a manner which allows the recipient freedom to dispose of it at will, even though it may have been obtained by fraud and his freedom to use it may have been assailable by someone with a better title to it.

In the instant case, the economic gain asserted to be flowing to petitioner Elmer Benes is not in the form of cash or checks. Rather, petitioner's benefit is a series of improvements made to real property which belonged to his wife * * *. These benefits were conferred upon him by the expenditure of funds by his corporation over a series of years; and the Commissioner's determination is that the total amount of such expenditures made by the company in each of the * * * years here involved, is taxable income to said petitioner * * *. It seems to us that somewhat different criteria must be applied in determining (as we must in the instant case) whether a stockholder has derived economic benefit from the expenditures made in his behalf toward the erection of a residence, from those which are applied where he has received cash from the corporation directly (as was true in the Davis and Leaf cases). The respondent suggests that the criteria properly to be applied in the instant case are: (1) Whether the petitioner * * * intended the * * * residence to be his residence from the very beginning; and (2) whether, while the residence was constructed * * * he had no intention to pay the corporation therefor, either as the residence construction passed through its varying stages toward completion, or upon ultimate completion. The petitioners appear to agree that these are the proper criteria. They seem reasonable to us; and we accordingly adopt them for use in the instant case.

In our case there is no question but what petitioner intended the Sewickley house to be his personal residence; therefore we need only address the second criteria of Benes,

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i.e., whether during the construction of the residence petitioner intended to pay for it either during the course of construction or upon its ultimate completion.

As a general rule, respondent's determination with respect to the residence would be presumptively correct and the burden would be upon petitioner to prove that the determination was erroneous. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). However, in this case if the amount attributed by respondent to petitioner's residence is removed from respondent's computation, there is no deficiency for 1968. As a result respondent cannot, and does not, rely upon his usual presumption of correctness with respect to the deficiency because in order to sustain his burden of proof with respect to fraud, it is incumbent upon respondent to affirmatively establish with clear and convincing evidence that there is some deficiency in tax due from petitioner for 1968. Kashat v. Commissioner, 229 F.2d 282 (6th Cir. 1956); Olinger v. Commissioner, 234 F.2d 823 (5th Cir. 1956); Drieborg v. Commissioner, 225 F.2d 216 (6th Cir. 1955); Hebrank v. Commissioner, 81 T.C. 640 (1983); and Jones v. Commissioner, 29 T.C. 601 (1957).

Consequently, even though petitioner admits that all of the materials and labor set forth in respondent's notice of deficiency were used in the construction of his residence and were paid for at least in substantial part by Three Rivers and/or Armour, respondent still has the burden of establishing that under the rule laid down in Benes, petitioner did not intend

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during the construction of the residence to repay Three Rivers and/or Armour for the cost of the construction. For the reasons set forth hereinafter, we find that respondent has failed to carry that burden.

First and foremost, we are convinced that prior to the end of 1968 and long before his 1968 return was even due, let alone filed, the truth with respect to the manner in which petitioner's house was constructed and paid for was known by Mr. Baggio, Mr. McCully, and a number of other subcontractors, as well as by Armour,[8] the Scott brothers, their accountant, and at least some of respondent's agents.

Secondly, with respect to petitioner's intention, during the construction in 1967 and 1968 he made it clear time and time again to a number of subcontractors that the materials and labor going into the house would all be paid for when he received his part of the profit from the Armour contract. Moreover, in McCully's case petitioner made no attempt to hide the fact that the invoices charged to E.W.A. 40 were being billed to Armour.

Thirdly, Gray, using for the most part figures furnished by respondent's agent, and other figures from the records of Three Rivers for which Gray was responsible, prepared petitioner's 1968

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[8] With respect to Armour, we, like the District Court, are at a loss to understand why the entire truth of the matter was not known as construction progressed, if in fact it was not known, by one or more of Armour's three employees including an accountant who were at the construction site and working with petitioner when the funds were being diverted into petitioner's house.

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return and did not include therein any reference to the lawsuit which had been pending for over a year in which it was alleged by Armour that petitioner had diverted funds into his house.

Fourthly, in view of the pending lawsuit which was a matter of public record and widely reported in the local press, little if any credence can be attributed to respondent's argument that petitioner not only failed to disclose the diversion of the funds into the house, but also made false statements and took other active steps to conceal such diversion.

Finally, while petitioner's shoddy record with respect to the filing of income tax returns for prior years might serve as a basis for an inference that the failure to file timely returns for 1967 and 1968 was willful, such record has no bearing upon petitioner's intention with regard to payment for the house. Furthermore, his record on past returns while admittedly unfavorable is not nearly as bad as respondent claims. Repeated statements at trial by respondent's counsel and agents, and by counsel on brief, to the effect that petitioner had not filed an income tax return since 1940 was not only misleading and totally unnecessary, but under the circumstances bordered on being an outright falsehood since petitioner was only 12 years old in 1940 and did not finish school until 1951. Moreover, respondent's own proof with respect to all of petitioner's adult years prior to 1968 (1952 through 1967) reveals that, after 15 years of off and on investigation by at least six different agents, respondent concluded that petitioner owed no income tax for 7 years, had

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overpaid his income tax by the end of 5 years, and owed relatively insignificant amounts for the remaining 4 years. The net findings in income tax by respondent's agents for these 16 years was $1,416.69, for an average of less than $100 per year, computed as follows:

Taxable Year	Tax Liability (Overpayment)
1952	$ -0-
1953	-0-
1954	-0-
1955	-0-
1956	-0-
1957	(116.74)
1958	(340.90)
1959	-0-
1960	1,181.12
1961	447.92
1962	504.78
1963	(374.00)
1964	-0-
1965	(763.00)
1966	(1,705.00)
1967	2,582.51
NET TAX DUE	$ 1,416.69

In view of all of the foregoing, we conclude that respondent has failed to establish that under the circumstances set out in our findings, petitioner did not intend during the construction of his house to repay Three Rivers and/or Armour for the amount of the materials and labor used therein. Instead, we are satisfied that it was petitioner's intention to repay the cost of such construction from his share of the anticipated profit from the Armour contract but was prevented from doing so by the termination of the contract by Armour and the subsequent litigation. Respondent, therefore, has failed to establish under

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Benes, that there is any deficiency in tax due from petitioner for 1968 and in the absence of a deficiency there is no basis for the imposition of the addition to tax for fraud under section 6653(b).

Decision will be entered for petitioner.

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T. C. Memo. 1986-439

UNITED STATES TAX COURT

ABRAHAM C. GROSSMAN and CHANA GROSSMAN, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 22974-82. Filed September 15, 1986.

Richard L. Goldman, for the petitioners.

Robert Schneps and Laurence Ziegler, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

JACOBS, Judge: Respondent determined a deficiency in petitioners' 1975 Federal income tax in the amount of $117,315.16 and an addition to tax of $17,597.27 under section 6651(a)(1).[1] The parties have settled all issues giving rise to the underlying deficiency in tax. The remaining issues for decision are: (1) whether petitioners' failure to timely file their 1975 tax return

[1] All statutory references are to the Internal Revenue Code of 1954, as amended and in effect in 1975.

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was due to reasonable cause; and (2) if not, whether in determining the amount of the addition to tax for late filing under section 6651(a)(1), the timely mailing-timely filing rule of section 7502(a) applies.

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulation of facts and attached exhibits are incorporated herein by this reference.

Abraham C. Grossman and Chana Grossman, husband and wife, resided in Brooklyn, New York at the time they filed their petition.[2] They filed their 1975 tax return late, citing the following as justification for the late filing.

Petitioner owned and operated a 49 bed nursing home located in the Bronx, known as Parkway Manor Nursing Home (Parkway Manor). By Agreement dated March 9, 1970 (the Agreement), petitioner agreed to sell a 50 percent ownership interest in Parkway Manor to Abraham and Lucy Gelbfish. Petitioner subsequently refused to convey an interest in Parkway Manor to the Gelbfishes; and beginning in 1971, protracted rabbinical arbitration and court litigation ensued.

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[2] Chana is a party herein solely because she filed a joint return with her husband for 1975; therefore Abraham will be referred to as petitioner.

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Parkway Manor was closed on July 15, 1974. On July 8, 1974, petitioner opened and began operating the Bruckner Nursing Home (Bruckner). Bruckner's operations were approximately 4-fold those of Parkway Manor.

Ultimately, in May, 1975, the dispute between petitioner and the Gelbfishes was resolved. Petitioner was ordered to pay the Gelbfishes $315,000; payment was to be made over a period of time (part in 1975) pursuant to a stipulation of settlement dated October 9, 1975. The Gelbfishes released all rights they had in Parkway Manor and Bruckner.

Petitioner's accountant, Isidore Eichenthal, was undecided as to the proper tax treatment of petitioner's obligation to the Gelbfishes.[3] He realized that the payment to the Gelbfishes could be a material item, in that it could potentially offset most of the profit earned by Bruckner and thereby reduce petitioners' 1975 tax liability.[4] Rather than prepare an incorrect return, Mr. Eichenthal obtained extensions of time for

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[3] Mr. Eichenthal considered the alternatives of treating the payment as (a) a deductible business expense, (b) a capital loss, or (c) a nondeductible capital investment. If it were a capital expenditure, additional deductions for depreciation and investment tax credit were possibilities. The timing of any deduction was also unclear because Bruckner used the accrual method of accounting whereas petitioner used the cash method.

[4] Bruckner's books for 1975 were closed in May, 1976. At that point, Mr. Eichenthal determined that Bruckner's 1975 profits approximated $349,000.

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filing so that the matter could be thoroughly examined. Three extensions of the April 15, 1976 due date were granted; the final extended date for petitioner's 1975 return was October 15, 1976.[5]

Shortly after Mr. Eichenthal had prepared the financial reports of Bruckner (in May, 1976), he spoke with petitioner's lawyer, Mr. Zafrin, in order to obtain additional information about the settlement stipulation. Mr. Eichenthal hoped, by understanding the facts and circumstances surrounding the settlement, to determine the tax consequences of petitioner's payments to the Gelbfishes. In June, 1976, however, Mr. Eichenthal concluded that he needed the assistance of a tax lawyer. Accordingly, on July 9, 1976, petitioner and Mr. Eichenthal met with Richard Goldman, a tax attorney. On August 3, 1976, Mr. Goldman wrote to Mr. Eichenthal as follows:

> Dear Mr. Eichenthal:
>
> We cannot tell how to advise without seeing Mr. Grossman's file. He was going to send it here, but we have not received it.
>
> Without it, it is difficult to go behind the stipulation although this is what (in effect) the Internal Revenue Service will do, to see how to treat the payments for tax purposes.
>
> Also, we would like to receive a retainer to apply against our charges at normal rates, and to cover any out-of-pocket disbursements.
>
> Sincerely,

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5 October 15, 1976 was the maximum extended date allowable under section 6081(a).

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(signed) Richard L. Goldman,
P.C.

P.S. — Please notice that I shall be away from this Sunday evening for 2 weeks, in case you would like to get the file to me to examine beforehand.

On September 8, petitioner mailed Mr. Goldman a retainer for his services. On September 9, Mr. Goldman, who was unaware that petitioner had sent him a retainer, left on a business trip and did not return until September 27.

Mr. Eichenthal and petitioner both observe the Jewish holidays. In 1976, October 4 was a Jewish holiday, as was the period of October 9-17. After the October 4 holiday, preparations had to be made for the holiday occuring during the October 9-17 period; therefore, Mr. Eichenthal did no work from October 4 through October 17.

On October 13, Mr. Goldman spoke with Mr. Zafrin requesting that Mr. Zafrin review petitioner's files and send Mr. Goldman copies of documents which were relevant to petitioner's tax question. On November 3, Mr. Zafrin forwarded to Mr. Goldman the documents Mr. Goldman had requested. On November 8, Mr. Goldman issued an opinion letter, which he supplemented on November 16. Mr. Eichenthal then completed petitioner's 1975 tax return and sent the return to them for execution on November 18. Petitioner and his wife signed the return on December 15, 1976; petitioner

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hand delivered the return to Mr. Eichenthal on the same day. The return was mailed to respondent on December 15, 1976, and was received by respondent on January 6, 1977.

Petitioner claims that his failure to timely file his 1975 tax return was due to reasonable cause and that he therefore is not liable for any additions to tax for late filing. Specifically, petitioner justifies his late filing because of his reliance on Mr. Eichenthal to prepare a proper return. He also contends that he was distracted due to (1) a State investigation of the nursing home industry which resulted in his being served with a "flood" of subpoenas, and (2) his observance of the Jewish holidays. Finally, petitioner argues that in any event the mailing date of the return, December 15, is the filing date, so that if the late filing is not deemed excusable, the amount of the addition for late filing should be 10 percent of the correct tax. Respondent claims that petitioner is liable for an addition to tax for late filing in the amount of 15 percent of the correct tax because (1) the return was received two and a fraction months late, and (2) petitioner's failure to timely file was not due to reasonable cause.

OPINION

Section 6651(a)(1) provides that where a return is not filed by the date prescribed therefor (including extensions), there shall be added to the amount required to be shown as tax on the return 5 percent of the amount of such tax for each month or

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fraction thereof during which the return is late up to a maximum of 25 percent. In order to avoid the addition for late filing, the taxpayer must show that the late filing was due to reasonable cause and not willful neglect. The term "reasonable cause" is not defined in the statute. However, the applicable Treasury regulations provide that if the taxpayer exercises ordinary business care and prudence and nevertheless is unable to file the return within the prescribed time, then the delay will be considered as due to reasonable cause. Section 301.6651-1(c)(1), Proced. & Admin. Regs.

Respondent does not argue that petitioner's failure to timely file his 1975 return was due to willful neglect. The applicability of the addition for late filing therefore depends on whether petitioner's failure was due to reasonable cause.

In our opinion, petitioner did not exercise ordinary business care and prudence. Petitioner's procrastination and his apparent cavalier attitude contributed largely to the late filing of the 1975 return. Petitioner delayed in engaging the services of a tax attorney; he delayed in paying the attorney a retainer; and he delayed in furnishing the attorney with necessary information. Once the information was furnished, the attorney was able to render an opinion in 13 days.

This Court and other courts have considered whether a taxpayer should be excused from the addition for late filing due to his reliance on a professional adviser. Haywood Lumber and Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950),

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modifying 12 T.C. 735 (1949); Ferrando v. United States, 245 F.2d 582 (9th Cir. 1957); Estate of Lammerts v. Commissioner, 456 F.2d 681 (2d Cir. 1972), affg. 54 T.C. 420 (1970) on this issue; Estate of DiPalma v. Commissioner, 71 T.C. 324 (1978). The outcome as to whether the addition for late filing should be imposed frequently has turned on the distinction between whether the taxpayer relied on advice that no return was required (which may be reasonable cause for failing to file timely), or whether the taxpayer relied on the adviser to timely file returns, where the taxpayer knows that a return must be filed (which is not reasonable cause). See, e.g., Estate of Duttenhoffer v. Commissioner, 410 F.2d 302 (6th Cir. 1969), affg. per curiam 49 T.C. 200 (1967). Where a taxpayer relies on his adviser to timely file a return, a further distinction was made as to whether the taxpayer takes affirmative steps to ensure that the return is timely filed (which is reasonable cause for failing to file timely), or whether the taxpayer delegates the obligation to file and then sits passively by, taking no further interest in the matter (which is not reasonable cause). Compare Estate of DiPalma v. Commissioner, supra with Estate of Lammerts v. Commissioner, supra.

As we noted in DiPalma, the cases in this area:

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> do no more than set forth a general rule * * * and do not abrogate the principle that whether the failure to file on time was due to reasonable cause is primarily a question of fact to be determined from all of the circumstances in a particular case. [Citations omitted.] Under these circumstances, a review of the numerous decisions on the issue "pro and contra [is] of little help." [Citations omitted. 71 T.C. at 327.]

The Supreme Court recently resolved much of the uncertainty in this area. In United States v. Boyle, 469 U.S. 241 (1985), the Court held that an executor who relied on an attorney to timely file an estate tax return could not avoid imposition of the late filing addition where, due to the attorney's clerical oversight, the return was filed three months late. The burden to file a timely return is that of the taxpayer, and not his agent.

Reliance on the advice of a lawyer or accountant may constitute reasonable cause for failing to file a timely return, where, for example, the taxpayer receives advice concerning a question of law, such as advice that he realized no taxable income and therefore no return is required. Here, petitioner received no such advice. On the contrary, petitioner knew that a return was required to be filed and that the last day for filing was October 15, 1976.

We are unpersuaded by petitioner's argument that the late filing was reasonable because he was distracted by the nursing home investigation or because of his observance of the religious holidays. Thus, we hold that petitioner's late filing was not due to reasonable cause.

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The only question remaining is the appropriate amount of the addition to tax under section 6651(a). Pursuant to section 7502, if respondent receives a return after the prescribed date for filing, but the return is enclosed in an envelope bearing a United States postmark date before the prescribed filing date, the return is deemed filed on the date of postmark. Section 301.7502-1(c), Proced. & Admin. Regs., provides that if the postmark on the envelope is made other than by the United States Post Office, then the timely mailing-timely filing rule set forth in section 7502 applies only if (1) the date of the postmark is on or before the last date for filing, and (2) the return is received not later than the time it ordinarily would have been received if it had been postmarked by the United States Post Office on the last date prescribed for filing.

We have held that the timely mailing-timely filing rule is inapplicable to delinquent returns. Sanderling v. Commissioner, 67 T.C. 176 (1976), affd. and revised on other issues 571 F.2d 174 (3d Cir. 1978). Where a return is mailed after its due date (including extensions), it is deemed filed on the date of receipt rather than on the date of mailing. The "prescribed date" for purposes of both sections 6651 and 7502 is the due date of the return, and not as petitioner argues, each monthly increment following the due date of the return. Sanderling v. Commissioner, supra.

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Petitioner concedes that he mailed his 1975 return after the October 15 due date. The timely mailing-timely filing rule therefore does not apply. When respondent received the return on January 6, 1977, two and a fraction months had elapsed since the prescribed filing date. The applicable rate of the addition to the tax for late filing under section 6651(a) is therefore 15 percent.

Because of concessions,

Decision will be entered under Rule 155

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T. C. Memo. 1986-440

UNITED STATES TAX COURT

DAVID J. SCHLOEGL, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 23511-82. Filed September 15, 1986.

David J. Schloegl, pro se.

Mark Pridgeon and Mary E. Pierce, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SWIFT, Judge: In a timely statutory notice of deficiency dated July 19, 1982, respondent determined deficiencies in petitioner's Federal income tax and self-employment tax liabilities as follows:

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Year	Deficiencies
1977	$ 999.00
1978	7,020.08
1979	8,674.37

Following concessions, the primary issues remaining for decision are: (1) Whether petitioner properly may use the completed contract method of accounting to reflect income received in 1978 and 1979; (2) whether petitioner may deduct expenses allegedly incurred in connection with his construction business in excess of those allowed by respondent; and (3) whether petitioner is entitled to an investment tax credit with respect to certain leased property.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. Petitioner, David J. Schloegl, was a resident of St. Paul, Minnesota, at the time of filing the petition herein. Petitioner timely filed Federal income tax returns (Forms 1040) for 1977, 1978, and 1979.

During the years in issue, petitioner was employed by Knox Lumber Company and also operated as a sole proprietor a construction business. The income and expenses of the construction business were reported on the cash method of accounting. In November of 1978, petitioner, on behalf of his construction business, entered into a contract to produce 4,000

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steel brackets for Knox Lumber Company. Under the contract he was to receive an advance payment of $7,100 in 1978. Petitioner produced approximately 250 brackets per week and completed the contract in 1979. Petitioner did not include the $7,100 advance payment in his 1978 Federal income tax return. Instead, he included all the income he earned under the 1978 contract with Knox Lumber Company in his 1979 Federal income tax return using the completed contract method of accounting.

In November of 1979, on behalf of his construction business, petitioner entered into a second contract with Knox Lumber Company to produce another 4,000 steel brackets. He received in 1979 an advance payment under this contract of $24,040. Petitioner did not include the $24,040 advance payment in his 1979 Federal income tax return. Petitioner completed the second contract in 1980. Petitioner did not file a Federal income tax return for 1980.

Petitioner claimed various expenses as Schedule C deductions on his Federal income tax returns for 1977, 1978, and 1979, which expenses allegedly were incurred during those years in connection with petitioner's construction business. Respondent disallowed many of the claimed expenses for lack of substantiation and because petitioner did not establish that the expenses were related to or incurred in connection with his business.

On his 1977, 1978, and 1979 returns, petitioner deducted as rent amounts allegedly paid to Franklin Auto Body, Inc., for the use of a building out of which petitioner conducted his

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construction business. Petitioner had occupied the property since 1975 under an oral agreement with Robert C. Wicker ("Wicker"), president of Franklin Auto Body. Petitioner, however, was not obligated under the agreement to pay Franklin Auto Body any stated monthly or yearly rent for use of the property. Petitioner performed repairs on the building in connection with the use of the building by his construction company but apparently the repairs were not based on any obligation owed to Wicker to make repairs to the building. Contrary to what is implied by its name, Franklin Auto Body was a real estate holding company operated and principally owned by Wicker, who also was petitioner's accountant and tax return preparer.

Petitioner deducted expenses for meals he purchased in 1978 and 1979 for Wicker and other individuals identified by petitioner as "unpaid help." Professional fees deducted by petitioner in those years allegedly were incurred for accounting services rendered by Wicker on behalf of petitioner's construction business.

On Schedule C of his 1979 return, petitioner deducted the cost of homeowner's insurance covering two residential properties, one owned by his mother and one owned by the estate of his father. Petitioner also purchased and installed a boiler for each residence, the cost of which he deducted as supplies used in his business.

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The Schedule C deductions claimed by petitioner and those allowed by respondent are summarized below:

	1977			1978			1979		
Deductions:	Claimed By P	Allowed By R	Amount in Dispute	Claimed By P	Allowed By R	Amount in Dispute	Claimed By P	Allowed By R	Amount in Dispute
Rent	$6,520	$72	$6,448	$6,744	$114	$6,630	$2,094	$544	$1,550
Meals	--	--	--	230	-0-	230	261	-0-	261
Prof. Fees	250	-0-	250	383	133	250	500	250	250
Insurance	--	--	--	--	--	--	951	174	777
Supplies	--	--	--	856	-0-	856	878	-0-	878
Total	$6,770	$72	$6,698	$8,213	$247	$7,966	$4,684	$968	$3,716

On his 1978 Federal income tax return, petitioner claimed an investment tax credit in the amount of $187.20 with respect to a stereo sound system he leased to Wicker Enterprises, Inc., a corporation controlled by Wicker. The written agreement executed by petitioner and Wicker on May 17, 1978, regarding the lease of the sound system reflected that annual lease payments were due from Wicker Enterprises in the amount of $500 beginning on May 17, 1979, throughout the five-year term of the lease. Apparently, however, none of the payments required under this lease were made by Wicker Enterprises.

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OPINION

Advance Payments received from Knox Lumber Company

Petitioner argues that under the completed contract method of accounting he properly may exclude the $7,100 and $24,040 advance payments from gross income in the year of receipt. Respondent argues that petitioner is not entitled to use the completed contract method of accounting because the contracts with Knox Lumber Company under which petitioner received the advance payments were not long-term contracts within the meaning of section 1.451-3(b)(1), Income Tax Regs.

Although a taxpayer generally is free to choose his method of accounting, the method chosen must consistently be applied and will be respected only where, in the opinion of the Commissioner, it clearly refects income. Sec. 446(b)[1]; sec. 1.446-1(a)(2), Income Tax Regs.; Reco Industries, Inc. v. Commissioner, 83 T.C. 912, 919-920 (1984), on appeal (4th Cir., July 30, 1985). Section 446(b) grants to respondent broad discretion to recompute a taxpayer's income under an accounting method that clearly reflects income and any such recomputation by respondent is entitled to a strong presumption of correctness. Commissioner v. Hansen, 360 U.S. 446, 467 (1959); Keller v. Commissioner, 725 F.2d 1173 (8th Cir. 1984), affg. 79 T.C. 7 (1982). The question of whether a particular accounting method clearly reflects income

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[1] All section references are to the Internal Revenue Code as in effect during the years in issue.

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is primarily a factual question that varies from business to business. Sam W. Emerson Co. v. Commissioner, 37 T.C. 1063, 1067 (1962).

Generally, advance payments are includable in the gross income of a cash basis taxpayer when actually or constructively received. Sec. 1.451-1(a), Income Tax Regs.; United States v. Wiese, 750 F.2d 674 (8th Cir. 1984); Beaver v. Commissioner, 55 T.C. 85 (1970). Under certain circumstances, however, a cash basis taxpayer may report amounts received in connection with a long-term contract under, among other permissible methods, the completed contract method of accounting, in which case all income attributable to or derived from the long-term contract is includable in gross income for the taxable year in which the contract is completed. Sec. 1.451-3(d)(1), Income Tax Regs.;[2] Reco Industries, Inc. v. Commissioner, supra at 921; Penninsula Steel Products & Equipment v. Commissioner, 78 T.C. 1029, 1039 (1982). A long-term contract is defined as a building, installation, construction, or manufacturing contract which is

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[2] Sec. 1.451-3(d)(1), Income Tax Regs., provides in relevant part:

> **(d) Completed contract method--(1) In general.** Except as otherwise provided in paragraph (d)(2), (3), or (4) (relating to disputes) of this section, under the completed contract method, gross income derived from long-term contracts must be reported by including the gross contract price of each contract in gross income for the taxable year in which such contract is completed * * *.

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not completed in the taxable year in which it is entered into provided the contract, insofar as manufacturing is concerned, involves the manufacture of--

> (a) unique items of a type which is not normally carried in the finished goods inventory of the taxpayer, or
>
> (b) items which normally require more than 12 calendar months to complete (regardless of the duration of the actual contract). [Sec. 1.451-3(b)(1)(ii), Income Tax Regs.]

Petitioner argues that his use of the completed contract method of accounting herein is proper because the contracts with Knox Lumber Company were not completed within 12 months and thus were long-term contracts. Respondent argues that the brackets manufactured by petitioner under the contracts were not unique items because petitioner produced 8,000 of them during the years 1978 and 1979. Moreover, respondent contends that because petitioner could produce as many as 250 brackets per week, his contracts with Knox Lumber Company were not long-term contracts within the meaning of section 1.451-3(b)(1), Income Tax Regs.

We agree with respondent. A multi-unit manufacturing contract is considered to be a long-term contract only if the manufacturing process requires more than 12 months to produce each individual unit. Section 1.451-3(b)(1)(ii), Income Tax Regs., provides as follows:

> [A] contract to manufacture 15,000 folding chairs which take 3 days each to manufacture is not a long-term contract * * * even though it takes more than 12 calendar months to manufacture all 15,000 chairs and

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> the contract is not completed within the taxable year it is entered into. [Sec. 1.451-3(b)(1)(ii), Income Tax Regs.]

Petitioner is not entitled to use the completed contract method of accounting for income received under the two contracts with Knox Lumber Company and must include in income the $7,100 and $24,040 advance payments received thereunder in accordance with the cash method of accounting. We sustain respondent on this issue.

Schedule C Deductions

Petitioner has failed to substantiate amounts deducted as rent on his Federal income tax returns for 1977, 1978, and 1979, in excess of the amounts allowed by respondent. With respect to the $6,448 in dispute for 1977, petitioner relies on five checks which petitioner issued to Wicker in July and August of 1977 and which petitioner alleges were in payment of rent. The notations on the checks, however, make it clear that $5,900 of the amount in dispute was a loan by petitioner to Wicker. Petitioner contends, however, that in December of 1977, he agreed to convert the $5,900 he had loaned to Wicker to a rental payment. On the record before us, however, there is no credible evidence that petitioner had a rental obligation that would support such a recharacterization of the $5,900 payment. Petitioner offered no evidence concerning the $348 balance of the rent in dispute for 1977.

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With respect to the $6,630 rental payment in dispute for 1978, petitioner submitted as substantiation for $770 thereof seven cancelled checks written in 1978 which were made payable either to Wicker or to alleged creditors of Wicker. Petitioner testified that he paid the remaining $5,860 of the 1978 rent in dispute to Wicker out of the proceeds of a loan he received from Connie Koller ("Koller"). As evidence of the loan from Koller, petitioner introduced a written loan agreement dated January 3, 1979, allegedly signed by Koller. In her testimony, however, Koller denied signing the agreement or loaning any funds to petitioner.[3]

To substantiate the $1,550 rental payment in dispute for 1979, petitioner introduced four handwritten memos signed by Wicker, each of which listed several alleged rental payments totalling $1,565. The memos also indicate that petitioner paid Wicker $1,000 in small amounts of cash throughout 1979, and that $565 in cash was paid to Wicker on an unspecified date from the proceeds of a second loan allegedly received by petitioner from Koller.

We are not convinced that the checks issued by petitioner to Wicker and to Wicker's alleged creditors in 1978 and 1979 were intended as payments of rent. The evidence indicates that Wicker

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[3] An employee of Wicker Enterprises, Inc., testified that she witnessed Koller sign the loan agreement with petitioner. That employee, however, began working for Wicker Enterprises in June of 1980, and thus could not have been present if the loan agreement was in fact executed on January 3, 1979.

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often gave petitioner cash amounts against which petitioner, as a convenience to Wicker, would issue his personal checks payable to Wicker's creditors. The seven checks written by petitioner in 1978 in favor of Wicker most likely represent such convenience checkwriting on Wicker's behalf.

We also reject petitioner's contention that he received loans from Koller in 1978 and 1979 to make rental payments. Koller denied making any loans to petitioner and other evidence relating to those purported loans is not consistent. On the one hand, petitioner testified that he received a $5,860 cash loan from Koller in 1978, the proceeds of which he paid to Wicker as rent. Wicker, however, suggested that the loan from Koller did not result in any money changing hands, and that petitioner simply assumed $5,860 of Wicker's outstanding debts to Koller. Whatever actually may have occurred, petitioner has failed to convince us that he is entitled to deductions for rent during the years in issue in excess of amounts allowed therefor by respondent. We sustain respondent on this issue.

Petitioner deducted on his 1978 and 1979 Federal income tax returns $230 and $261, respectively, for meals he contends were purchased for Wicker and other "unpaid help" in connection with his business. Section 274(d) provides that a taxpayer must substantiate by adequate records or by sufficient evidence corroborating his own statement the amount, time, place, and business purpose of travel and entertainment expenses, including business meals, and the business relationship to the taxpayer of

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the person entertained. To substantiate meal expenses deducted on petitioner's 1978 return, petitioner submitted a list of 18 meals purchased by petitioner and with either Wicker's name or the notation "unpaid help" associated with each meal. Petitioner did not include in the list the business purpose of the meals. Petitioner also introduced 17 of his cancelled checks which correspond with 17 of the meals listed and which indicate the amount of each meal and the restaurant in which the meals were purchased. To substantiate meal expenses deducted on his 1979 return, petitioner introduced several of his cancelled checks, but he did not introduce any list or description of the meals. None of the 1978 or 1979 checks nor any other documentation identify the business purpose of the meals.

We agree with respondent that the documentation submitted by petitioner does not rise to the standard of proof required by section 274(d) to substantiate expenses for business meals. We hold for respondent on this issue.

Petitioner deducted $250, $383, and $500 in 1977, 1978, and 1979, respectively, for fees paid to Wicker for accounting services relating to petitioner's construction business. Of those amounts, respondent allowed $133 in 1978 and $250 in 1979, but disallowed for lack of substantiation the remaining $250 claimed in each of the years in issue. Petitioner submitted a letter signed by Wicker stating that Wicker had been paid accounting fees by petitioner in the full amount deducted on petitioner's returns. In light of petitioner's testimony and the

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letter from Wicker, we conclude that petitioner is entitled to deduct the accounting fees paid in 1977, 1978, and 1979, as claimed on petitioner's returns.

With regard to the cost of two homeowner's insurance policies and supply expenses claimed on his 1979 Federal income tax return, petitioner testified that the insurance premiums were paid to protect and insure his expected inheritance and that the supplies related to an agreement with the executor of his father's estate to repair portions of the estate property but he did not elaborate as to the terms of any such agreement. Petitioner offered no explanation of how the repairs to his mother's property were connected to his business.

We agree with respondent that petitioner has failed to establish that the insurance premiums and supplies he purchased were related to his construction or any other trade or business of petitioner and that they are not allowable.

Investment Tax Credit

With regard to the investment tax credit in the amount of $187.20 relating to the stereo sound system petitioner leased to Wicker Enterprises, petitioner submitted a written lease agreement dated May 17, 1978, which reflected an annual lease payment due from Wicker Enterprises of $500 throughout the five-year term of the lease. Respondent disallowed the investment tax credit because petitioner, as a noncorporate lessor, failed to qualify for the credit under section 46(e)(3).

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Section 46(e)(3)[4] provides that a noncorporate lessor who did not manufacture or produce the property must meet two conditions in order to be entitled to an investment tax credit in leased property. First, the term of the lease (taking into account options to renew) must be less than 50 percent of the useful life of the leased property. Second, the lessor (petitioner herein) must incur expenses with respect to the leased property during the first 12 months after the property is transferred to the lessee in an amount exceeding 15 percent of the rental income produced by the leased property. Sec. 46(e)(3)(B). Thus, in order for petitioner to be entitled to the claimed investment tax credit, he must prove that the useful life

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[4] Sec. 46(e)(3) provides:

> **(3) Noncorporate lessors.**--A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if--
>
> (A) the property subject to the lease has been manufactured or produced by the lessor, or
>
> (B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.
>
> * * *

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of the sound system exceeded 10 years and that he incurred expenses between May 17, 1978, and May 17, 1979, in connection with the sound system which exceeded $75 (15 percent of $500).

Petitioner contends that the sound system leased to Wicker Enterprises had a useful life of at least 15 years and that because he received no income from the lease during 1978, any business expense he incurred would exceed 15 percent of zero and thus qualify the investment for the investment tax credit under section 46(e)(3)(B).

Respondent argues that petitioner is not entitled to the investment tax credit with respect to the leased sound system because petitioner has failed to present any evidence of the useful life of the sound system other than the seven-year useful life reported therefor on the schedule for depreciation included in his 1978 tax return. Further, respondent argues that petitioner has failed to prove the amount of the expenses he incurred with respect to the sound system during the first 12 months of the lease.

For the reasons indicated by respondent, we agree that petitioner is not entitled to an investment tax credit with respect to the sound system. Petitioner has failed to present any evidence or testimony to establish the useful life of the sound system or the amount of the expenses he incurred with respect to the sound system.

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Other Miscellaneous Issues

In his notice of deficiency, respondent disallowed deductions in the amounts of $31, $46, and $4 in 1977, 1978, and 1979, respectively, for depreciation of equipment and allowed the cost of that equipment as part of cost of goods sold. Petitioner presented no evidence or testimony at trial on this issue and makes only vague arguments with respect thereto on brief. We sustain respondent on this issue.

On his 1979 Federal income tax return, petitioner deducted a total of $736 for real estate taxes paid with respect to his residence at 395 Daly Street. In his notice of deficiency, respondent disallowed 34 percent of that amount ($251) as a Schedule C expense, but allowed that same amount as an additional itemized deduction on petitioner's Schedule A. Petitioner contends that the property at 395 Daly Street was used by him entirely for business purposes and that he is entitled to deduct 100 percent of the real estate taxes he paid with respect thereto as a Schedule C business expense. Petitioner, however, offered no evidence which would overcome the presumption of correctness attaching to respondent's determination on this issue. Respondent's allocation of the use of the property (2/3 for business use and 1/3 for personal use) is reasonable, and we sustain respondent on this issue.

Finally, petitioner argues that he is not liable for self-employment taxes for the years in issue because he contends that he did not have taxable income from his business in excess of

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$400 in any of those years. Respondent correctly notes that the resolution of this issue is dependent upon our determination of the other issues herein. In light of our resolution of those issues, petitioner did have taxable income from his construction business in excess of $400 in each of the years in issue and the self-employment tax applies. We so hold.

Decision will be entered under Rule 155.

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T. C. Memo 1986-441

UNITED STATES TAX COURT

ROBERT D. STALLINGS AND BETTY A. STALLINGS, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 34280-85. Filed September 15, 1986

Robert D. Stallings, pro se.

Michael A. Urban, for the respondent.

MEMORANDUM OPINION

GUSSIS, Special Trial Judge: This case was assigned to Special Trial Judge James M. Gussis pursuant to section 7456(d)(3) of the Internal Revenue Code of 1954 and Rules 180,

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181 and 182 of the Tax Court Rules of Practice and Procedure.[1]

Respondent determined a deficiency in petitioners' Federal income tax for 1983 in the amount of $6,392 and also determined the following additions to tax: (1) under section 6653(a)(1) in the amount of $319.60; (2) under section 6653(a)(2) in the amount of 50 percent of the interest due on the underpayment of $6,392; (3) under section 6651(a)(1) in the amount of $135.36; and (4) under 6661(a) in the amount of $639.20. The issues are (1) whether wage income and other compensation payments received by petitioners in 1983 constitute taxable income; (2) whether the underpayment of tax was due to negligence or intentional disregard of rules and regulations; (3) whether petitioners failed to file a timely return for 1983 within the meaning of section 6651(a)(1); (4) whether there was a substantial understatement of income tax for the year 1983 within the meaning of section 6661(a); and (5) whether the Court should award damages to the United States under section 6673.

Some of the facts were stipulated and they are so found. Petitioners were residents of Houston, Texas at the time the petition herein was filed. Their 1983 Federal income tax return was filed on June 24, 1984.

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1 All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise indicated, and all Rule references are to the Tax Court Rules of Practice and Procedure.

During the year 1983 petitioner Robert D. Stallings received wages in the total amount of $39,522.71 and unemployment compensation in the amount of $1,616. Petitioner Betty A. Stallings also received compensation in 1983 in the amount of $2,179.

Petitioners apparently believe that they are entitled to deduct the "cost" of their labor and services from their wages and compensation, thus yielding them no taxable income. Their so-called "redress for grievances" simply encompasses arguments which have been repeatedly rejected by this and other Courts and require no extensive discussion. It is well settled that wages and compensation for services or labor are includable in gross income. Eisner v. Macomber, 252 U.S. 189 (1920), with no reduction for the "cost" or the purported value of the labor performed. Abrams v. Commissioner, 82 T.C. 403 (1984); Rowlee v. Commissioner, 80 T.C. 1111 (1983); Reading v. Commissioner, 70 T.C. 730 (1978), affd. 614 F.2d 159 (8th Cir. 1980). Unemployment compensation is includable, with certain adjustments, in taxable income under the provisions of section 85. There is no merit whatever in petitioner Robert D. Stalling's contention that he is not a "person" subject to taxes. See sections 1, 6001, 6011 and 6012; Rowlee v. Commissioner, supra at 1120. Moreover, respondent is authorized by statute upon the determination of a deficiency to send a notice of deficiency to the taxpayer, section 6212, and this Court has

jurisdiction over income tax cases. Burns, Stix and Friedman & Co., Inc. v. Commissioner, 57 T.C. 392 (1971). We conclude that wages and compensation received by petitioners, as well as the unemployment compensation, are includable in petitioners' taxable income for the year 1983. Respondent is sustained.

The next issue is whether petitioners are liable for additions to tax under sections 6653(a)(1) and (2) for negligence or intentional disregard of rules and regulations. Petitioners have the burden of proof. Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972). In the absence of any persuasive evidence on this issue, we must sustain respondent's determination as to the addition to tax under sections 6653(a)(1) and (2), with the section 6653(a)(2) addition to be computed on an underpayment of $6,392.

Respondent determined an addition to tax under section 6651(a)(1) for failure to file a timely return for 1983. It is clear on this record that petitioners' return was untimely filed. Moreover, petitioners made no effort to show that such failure was due to reasonable cause and not due to wilful neglect and consequently have failed to meet their requisite burden of proof on this issue. We must therefore sustain respondent's determination as to addition to tax under section 6651(a)(1).

Respondent determined that section 6661(a) is applicable under the facts of this case. We agree. Section 6661(a) provides that in the event of a substantial understatement of

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income tax for any taxable year, there should be added to the tax an amount equal to 10 percent of any underpayment attributable to such understatements. Section 6661(b) states that a "substantial understatement" exists if the amount of the understatement of income tax for the year exceeds the greater of (1) 10 percent of the tax required to be shown on the return, or (2) $5,000. It is clear on the facts of this case that a substantial understatement of income tax exists for the year 1983 and we therefore sustain the addition to tax determined by respondent under section 6661(a).

We next consider respondent's motion to award damages to the United States under section 6673. Said section provides that the Tax Court shall award damages to the United States not in excess of $5,000 where it appears to the Court that the proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless. The stale and thoroughly discredited arguments presented by petitioners in this case are manifestly frivolous and groundless. See McCoy v. Commissioner, 76 T.C. 1027, 1029-1030 (1981), affd. 696 F.2d 1234 (9th Cir. 1983). The inescapable inference compelled by this record is that petitioner instituted and maintained this proceeding

primarily for delay. Accordingly, we award damages to the United States under the provisions of section 6673 in the amount of $1,000.

Decision will be entered for the respondent.

JU 11.7/2: 1986-442

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T. C. Memo. 1986-442

UNITED STATES TAX COURT

WILLIAM G. DICKIE, JR. AND JENNIFER K. DICKIE, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

WILLIAM G. DICKIE, JR., Petitioner
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 2970-85,
2971-85.

Filed September 15, 1986.

Held: Petitioner did not have a "home" from which he was away within the meaning of sec. 162(a)(2), I.R.C. 1954, during 1980 and 1981 while working as a contract engineer.

John D. Milton, Jr., for the petitioners.

Lynn C. Washington, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

FEATHERSTON, Judge: Respondent determined the following deficiencies in petitioners' Federal income taxes:

Docket No.	Year	Amount
2970-85	1981	$5,663
2971-85	1980	$4,417

The issue presented for decision is whether personal living expenses incurred by petitioner William G. Dickie, Jr., during 1980 and 1981 at places away from Jacksonville, Florida, are deductible under section 162(a)(2)[1] as traveling expenses while away from home in the pursuit of a trade or business.

Petitioners make no argument on the includibility in their gross income of reimbursement payments made to petitioner William G. Dickie, Jr., to defray certain living expenses during 1980 and 1981. We treat the issue as abandoned.

FINDINGS OF FACT

At the time the petitions in these consolidated cases were filed, petitioners resided in Indianapolis, Indiana. Petitioner William G. Dickie, Jr., filed an individual Federal income tax return for 1980. He and petitioner Jennifer K. Dickie were married on September 5, 1981, and they filed a joint Federal income tax return for 1981. Both income tax returns were filed with the

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise noted.

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Internal Revenue Service Center, Atlanta, Georgia. The issues here presented are attributable to the activities of William G. Dickie, Jr., and for the sake of convenience he will be referred to as petitioner.

Petitioner was reared in Jacksonville, Florida. Following his parents' divorce in 1965, he lived with his father in that City. He graduated from high school in Jacksonville in May 1969 and from Auburn University, located in Auburn, Alabama, with a degree in mechanical engineering, in March 1975. While pursuing studies leading to his degree, he participated in a cooperative study and work program, attending the University and working for Pratt and Whitney Aircraft (Pratt and Whitney) in West Palm Beach, Florida, alternate calendar quarters from June 1970 through March 1974.

From March to June 1975, petitioner attended graduate school at Auburn University, worked as a graduate research assistant, and lived in Auburn, Alabama. From June 1975 to March 1976, petitioner worked full time for Gee & Jensen Engineers, Architects and Planners, and lived in West Palm Beach. In March 1976, he returned to the employ of Pratt and Whitney as a full-time design engineer and continued in that employment until June 1978, living in West Palm Beach.

In June 1978, petitioner decided to investigate seeking employment as a contract engineer. He contacted Belcan Corporation (Belcan), a corporation which specializes in obtaining employment for contract engineers, to discuss the possibility of

getting contract engineer assignments. A "contract engineer" is one who is employed by a contract service firm, such as Belcan, which provides engineering services for client companies. A contract engineer is usually paid at a higher hourly rate than regularly employed engineers and his assignments may be at locations anywhere in the country. The average length of a contract engineer's assignments during the relevant period was 8 to 12 months but many such assignments last one to two years or longer. Petitioner decided to become a contract engineer because of the anticipated greater monetary compensation, the prospects of seeing different parts of the country, and the professional challenge of new engineering assignments.

Belcan was interested in attempting to obtain employment for petitioner but did not want to talk with him while he was still employed by Pratt and Whitney. In June 1978, petitioner left his employment with Pratt and Whitney in West Palm Beach and returned to Jacksonville where he stayed for almost three months while searching for employment as a contract engineer. No such positions could be found in the Jacksonville area, and in August 1978 he obtained an employment assignment with Belcan for a contract it had with Detroit Diesel Allison (hereinafter Diesel) in Indianapolis, Indiana.

Prior to the scheduled reporting date for his Indianapolis assignment, Belcan advised petitioner by letter dated September 6, 1978, concerning the anticipated duration of the assignment at Diesel. The letter advised, in part, that:

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> Detroit Diesel Allison issues a 6 month purchase order to cover the cost of services for stress analysts. I realize you had requested confirmation of an assignment duration of at least 1 year to justify going up there. Detroit Diesel Allison feels that 6 months is the longest period of time that they could commit to at this point, and they caution further that the purchase order could be canceled at any time. In that case they would offer the courtesy of a 1 week notice. In the event that everything works out, there is a possibility of extensions to the purchase order, but will not be known until the end of the original 6 month period.
>
> Since we do not pay any expenses for moving, or temporary living expenses, I would suggest that you find temporary quarters in Indianapolis, and continue to maintain your permanent home. * * *

Petitioner's employment at Diesel lasted from September 1978 until April 25, 1980, a period of approximately 20 months. His work for Diesel involved the performance of finite element stress analysis of turbojet compressor discs and blades. During this period, he lived in two different rented apartments, in one from September 10, 1978 to March 1, 1979, and in the other from March 1, 1979 to April 25, 1980.

For the period from April 25, 1980 through July 14, 1980, petitioner was unemployed and he stayed with his father in Jacksonville. While unemployed, he received unemployment compensation. During May and June 1980, petitioner contacted three potential employers in Jacksonville and 30 to 50 potential employers at other United States locations.

In July 1980, petitioner obtained another employment assignment through Belcan for a contract with Williams Research in Walled Lake, Michigan. The underlying contract for which petitioner's services were required related to work on an automotive

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gas turbine contract. Work on this contract continued through April 1981. Petitioner was then shifted to work on a second Government contract for Williams Research involving cruise missile engines. Petitioner was employed at Williams Research continuously from July 1980 through June 1983, when he obtained a position as a regular engineer (no longer in the contract engineer category) with Diesel in Indianapolis, Indiana.

While employed in Walled Lake, petitioner lived in a rented apartment in Wixom, Michigan, from July 17, 1980 to July 30, 1981, and in a rented house from July 30, 1981 to June 1983. As noted above, petitioner and petitioner Jennifer K. Dickie were married on September 5, 1981.

During 1980, petitioner had a checking account at the Merchants National Bank and Trust Company in Indianapolis, Indiana. During 1980 and at least part of 1981, he had a checking account at a branch of the Community National Bank of Pontiac, Michigan, located in Walled Lake, Michigan.

Petitioner maintained a number of connections with Jacksonville. He had three cars and a boat during 1980 and 1981, and all of them were registered and tagged in Duval County, Florida. His driver's license was issued by the State of Florida, and he voted in the 1980 presidential election by absentee ballot in Florida.

During 1980, petitioner visited Jacksonville seven times for a total of approximately 90 to 100 days, including the period of his unemployment. During 1981, he visited Jacksonville six times

for a total of approximately 25 days. The majority of these visits were on weekends and holidays.

When he visited Jacksonville, petitioner stayed with his father and used the bedroom he occupied as a child while growing up in that City. He left many of his personal belongings at his father's home. In addition, he rented from a neighbor for $65 per month a two-car detached garage where he kept two vehicles and some automotive parts and boxes. The telephone at petitioner's father's home was, beginning sometime in 1981, listed in petitioner's name as well as his father's.

Petitioner had no rental or other agreement with his father with respect to the use of his father's home. Prior to August 1980, petitioner made no contributions to his father for the use of his home or to help defray the cost of maintaining it. In August 1980, shortly after the end of the period of his unemployment from April 25, 1980 through July 14, 1980, and following a consultation with the accountant who prepared his 1979 income tax return, petitioner sent his father a check in the amount of $503.04. During 1981, petitioner sent his father checks in the following amounts on the dates shown:

Date	Amount
January 29	$ 25.00
March 9	$ 25.00
April 2	$ 25.00
May 14	$ 25.00
June 23	$226.34
August 4	$ 57.00
October 4	$ 50.00

The June 23, 1981, check for $226.34 included $176.34 to reimburse his father for amounts spent on petitioner's boat and the August 4, 1981, check for $57 included $32 to reimburse his father for amounts spent on petitioner's car. Petitioner's father regarded the other amounts of the checks "as a gift of [petitioner] trying to help pay some of the expenses of the house." Petitioner's father was free to and did use the money he received from petitioner for any purpose he chose.

Petitioner's income tax returns for 1980 and 1981 show the following amounts of contract engineering income and employee business expense deductions:

Year	Engineering Income	Employee Business Expenses
1980	$44,402.00	$ 7,038.00
1981	$51,577.50	$11,937.00

Respondent disallowed the employee business expense deductions.

The parties have stipulated:

> Petitioner concedes that $300 of the employee business expenses claimed for 1980 are [sic] not deductible under any circumstances and $1,198 of the employee business expenses claimed for 1981 is not deductible under any circumstances. Respondent concedes that $2,828 of the employee business expenses disallowed for 1980 are deductible in any event and $711.86 of the employee business expenses disallowed for 1981 are deductible in any event. Accordingly, the only amounts disallowed for 1980 and 1981 remaining at issue in this action are $5,111 of traveling expenses for 1980 and $12,931.14 of traveling expenses for 1981.
> * * *

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OPINION

Section 162(a)(2)[2] provides that there shall be allowed as a deduction all ordinary and necessary traveling expenses (including amounts expended for meals and lodging) paid or incurred during the taxable year while "away from home" in pursuit of a trade or business. Section 262,[3] on the other hand, states that, except as otherwise provided, no deduction shall be allowed for "personal, living, or family expenses." The issue to be decided is whether petitioner was "away from home," within the meaning of section 162(a)(2), while working during 1980 and 1981 in Indianapolis, Indiana, and Walled Lake, Michigan.

The purpose for allowing the section 162(a)(2) deduction for traveling expenses while away from home is to ease the burden which falls upon a taxpayer who, because of the exigencies of his trade or business, must bear the duplicate expense of maintaining a residence and of living on the road. Rosenspan v. United

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2 SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including-- * * *

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; * * *

3 SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

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States, 438 F.2d 905, 912 (2d Cir. 1971); Bochner v. Commissioner, 67 T.C. 824, 828 (1977). Ordinarily, the taxpayer will choose to live near where he works, and the costs of his meals and lodging are nondeductible personal expenses under section 262. Thus, a taxpayer's "home," for purposes of section 162(a)(2), is generally his place of abode at or near his principal place of business. Michel v. Commissioner, 629 F.2d 1071, 1073 (5th Cir. 1980), affg. per curiam a Memorandum Opinion of this Court; Curtis v. Commissioner, 449 F.2d 225, 227 (5th Cir. 1971), affg. a Memorandum Opinion of this Court; Jones v. Commissioner, 444 F.2d 508, 509 (5th Cir. 1971), affg. 54 T.C. 734 (1970).

Implicit in these principles is a requirement that the taxpayer must have a "home" to be "away from" in order to qualify his otherwise personal expenses as traveling expenses deductible under section 162(a)(2). An itinerant worker without a permanent home for which he incurs substantial continuing living expenses does not qualify for the section 162(a)(2) deduction while on the road; he does not have the burden of duplicate expenses that section 162(a)(2) is intended to ease. Brandl v. Commissioner, 513 F.2d 697, 699 (6th Cir. 1975), affg. a Memorandum Opinion of this Court; James v. United States, 308 F.2d 204, 206-207 (9th Cir. 1962); Bochner v. Commissioner, 67 T.C. at 828.

Petitioner argues that Jacksonville was his section 162(a)(2) tax home while he was working as a contract engineer and that he was away from home while working in Indianapolis and

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Walled Lake. He argues that his Indianapolis and Walled Lake assignments were temporary in nature and that he did not, therefore, establish a home at those locations.[4] On this ground, he contends that he is entitled to deduct the living expenses that he incurred while working in Indianapolis and Walled Lake during 1980 and 1981. Respondent does not deny that petitioner incurred the disputed expenses but maintains that, within the meaning of section 162(a)(2), petitioner did not have a Jacksonville home from which he was away during those years.

We hold for respondent. Upon becoming a contract engineer, petitioner launched his chosen career as, in the words of his counsel, a "perpetual itinerant" worker whose assignments were "forecast to be and always are of a temporary nature." One of the reasons he chose this type of work was the prospect of seeing different parts of the country. The average length of a contract engineer's assignment at that time was 8 to 10 months and, at the end of each such assignment, petitioner expected to seek another similar one. He was unmarried during all of 1980 and most of 1981 and had no obligation to, and did not, maintain a residence at any particular location during 1980 and 1981. Petitioner did

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[4] An exception is made to the general rule that a taxpayer's home is in the vicinity of his place of employment; a taxpayer engaged in temporary employment may be permitted to deduct his duplicative expenses for meals and lodging. Jones v. Commissioner, 444 F.2d 508, 510 (5th Cir. 1971), affg. 54 T.C. 734 (1970); Commissioner v. Peurifoy, 254 F.2d 483, 486 (4th Cir. 1957), revg. 27 T.C. 149 (1956), affd. per curiam 358 U.S. 59 (1958). This exception is grounded on the assumption that it would be unreasonable to expect a taxpayer to move his home to the location of temporary employment. Kroll v. Commissioner, 49 T.C. 557, 562 (1968).

not have a "home" to be "away from" within the meaning of section 162(a)(2) and is not, therefore, entitled to deductions for his traveling expenses during those years.

Petitioner has not shown that his father's house in Jacksonville was his tax home during 1980 and 1981. Before beginning his career as a contract engineer, petitioner had not lived in Jacksonville for years. As detailed in our findings, from June 1970 to March 1974, he participated in a cooperative work-study program, dividing his time between attending classes at Auburn University and working for Pratt and Whitney Aircraft in West Palm Beach. From June 1975 through June 1978, he worked full-time in West Palm Beach, first with Gee & Jensen Engineers, and then with Pratt & Whitney Aircraft. The evidence does not show that he had any connection whatever with Jacksonville during this period other than the facts that it was the place where he lived as a child and his father still lived there.

True, petitioner stayed with his father in Jacksonville for nearly 3 months from June until early September 1978 while awaiting a contract engineer assignment. But he did not expect to work there or make Jacksonville his home. He was looking for work elsewhere. Belcan, the engineering services firm through which he sought a contract engineer assignment, had no customers in the Jacksonville or Northern Florida area. There was, therefore, no prospect that a contract engineer assignment would permit him to live in the Jacksonville area.

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Although petitioner began his first assignment as a contract engineer in September 1978, the evidence shows that he did not contribute in anyway to the maintenance of his father's home before August 1980. At that time, he sent his father a check for $503.04 and, during 1981, he sent his father approximately $25 per month. Petitioner would have us conclude that these nominal sums were substantial contributions to the maintenance of a Jacksonville residence--a home--for himself and his father. We do not agree.

Cast in the most favorable light from petitioner's standpoint, the contributions were sums given by a financially successful son to his less successful father with whom he had always maintained a close personal relationship. In fact, however, the evidence suggests that the payments were made for tax reasons. He began making them following his consultation with his accountant on the deductibility of his personal and living expenses while working as a contract engineer. After that consultation, petitioner arranged to have his name listed in the Jacksonville telephone directory and began making the payments to his father.[5]

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5 Petitioner offered evidence also to show that he visited his father in Jacksonville several times in 1980 and 1981, that he stayed in the room he occupied as a child, that the room had in it the furniture he used as a child, that he voted in Florida in 1980, that his cars were registered in Florida, and that he had a Florida driver's license. These facts are not controlling. As explained in Scotten v. Commissioner, T.C. Memo. 1966-206, affd. per curiam 391 F.2d 274 (5th Cir. 1968):

> Surely "home" is not simply where the heart lies. If this were true, it would open the floodgates for the deduction of all kinds of personal living expenses, for many of us have moved from our birthplaces, returned

(footnote continued)

The payment of such nominal sums, moreover, must be compared with the deductions of $7,038 for 1980 and $11,937 for 1981 here in dispute. The ratio of claimed deductions to the gifts to his father was about 14 to one for 1980 and 53 to one for 1981; this is hardly the sort of duplication of substantial home expenses that justifies a section 162(a)(2) deduction. Brandl v. Commissioner, 513 F.2d 697, 699 (6th Cir. 1975), affg. a Memorandum Opinion of this Court; James v. United States, 308 F.2d 204, 207-208 (9th Cir. 1962); Bochner v. Commissioner, 67 T.C. 824, 828 (1977); Scotten v. Commissioner, T.C. Memo. 1966-206, affd. per curiam 391 F.2d 274 (5th Cir. 1968).[6]

Respondent argues alternatively that petitioner's assignments in Indianapolis and Walled Lake were intended to be, and were, for indefinite rather than temporary periods and that petitioner's home was in the vicinity of his employment in those cities. We need not consider that argument.

(footnote continued from previous page)
often to visit our relatives and friends, and intend to some day go back "home" to stay. Obviously this is not enough to entitle us to deduct all of our personal living expenses while "away from home."

[6] The Court has reached a similar conclusion in a growing list of cases involving contract engineers who have made nominal contributions to their parents or otherwise attempted to show attachments to their hometowns as bases for deducting their personal and living expenses under sec. 162(a)(2). See Spinks v. Commissioner, T.C. Memo. 1985-588; Lichtenberger v. Commissioner, T.C. Memo. 1985-370, affd. without a published opinion 789 F.2d 919 (7th Cir. 1986); Deamer v. Commissioner, T.C. Memo. 1984-63, affd. per curiam 752 F.2d 337 (8th Cir. 1985); Rohr v. Commissioner, T.C. Memo. 1982-117; Kaye v. Commissioner, T.C. Memo. 1974-111.

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To reflect the foregoing,

Decisions will be entered under Rule 155.

JU 11.7/2:1986-443

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T. C. Memo. 1986-443

UNITED STATES TAX COURT

BETTE J. SHEARER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 1211-83. Filed September 15, 1986.

Bette J. Shearer, pro se.

Jonathan J. Ono, for the respondent.

MEMORANDUM OPINION

SHIELDS, Judge: Respondent determined deficiencies in and additions to petitioner's income taxes as follows:

Year	Deficiency	Additions to Tax Section 6653(b)[1]	Section 6654
1980	$ 8,708.24	$ 4,354.12	$ 173.45
1981	8,438.00	4,219.00	573.04

[1] All section references are to the Internal Revenue Code of 1954, as amended, during the years in issue unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

C.M./VL

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At the conclusion of the trial in this case, we granted respondent's motion for summary judgment as to the deficiencies in tax and the additions to tax under section 6654. Thus, only two issues remain for decision: (1) whether petitioner is liable for the addition to tax under section 6653(b) for fraud; and (2) whether petitioner is liable for damages under section 6673.

Petitioner resided in Las Vegas, Nevada at the time the petition in this case was filed. During the years 1978 through 1981, she was employed as a manager by Safeway Stores. ("Safeway"). She filed income tax returns for 1978 and 1979, but not for 1980 and 1981, even though she received wages, and Forms W-2 reflecting such wages, from Safeway of $32,695.99 in 1980 and $32,340.03 in 1981. During 1981, petitioner filed with Safeway two W-4 forms on which she falsely claimed she was exempt from income tax withholding.

In her reply to respondent's answer, petitioner asserted that she is not liable for income tax because her wages are a "source, not an income" and are not taxable under section 61. She also claimed that the United States Tax Court is unconstitutional and that the Federal monetary system is invalid. Before trial, she refused to stipulate to facts which are not reasonably deniable, and at trial, she refused to present any proof, to be placed under oath, or to be questioned by the Court or by respondent's counsel. In addition, she left the courtroom upon being asked by the Court whether she was recording the proceedings.

Additions to Tax Under Section 6653(b)

Respondent determined that petitioner is liable for the addition to tax for fraud as provided by section 6653(b). On this issue he has the burden of proving by clear and convincing evidence that there was some underpayment in each year and that part of the underpayment was due to fraud. Section 7454(a); Rule 142(b). The burden with respect to fraud is met if it is shown that the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. Stoltzfus v. Commissioner, 398 F.2d 1002, 1004 (3d Cir. 1968), cert. denied 393 U.S. 1020 (1969); Webb v. Commissioner, 394 F.2d 366 (5th Cir. 1968), affg. a Memorandum of this Court; Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983).

The presence or absence of fraud is a question of fact to be determined from the entire record. Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Fraud is never presumed but must be established by affirmative evidence. Beaver v. Commissioner, 55 T.C. 85 (1970). It may, however, be proved by circumstantial evidence because direct proof of the taxpayer's intent is rarely available. The taxpayer's entire course of conduct may be examined in order to determine whether the fraudulent intent is present. Stone v. Commissioner, 56 T.C. 213, 223-224 (1971); Otsuki v. Commissioner, 53 T.C. 96, 105-106 (1969).

Petitioner's conduct in this case leads to the inescapable conclusion that her sole objective and intent was to evade the payment of taxes which she knew to be owing. She failed to file income tax returns in 1980 and 1981 even though she knew that she was required to file such returns, as evidenced by her filing of returns in 1978 and 1979. In addition, she filed false W-4 forms with her employer with the obvious intention of preventing the withholding of any income tax from her wages. Last, petitioner failed to cooperate in any way with the preparation of this case for trial, and her conduct at the trial was disrespectful, disruptive and totally unreasonable.

We conclude, therefore, that respondent has shown by clear and convincing evidence that petitioner's underpayments for 1980 and 1981 were due to fraud.

Damages Under Section 6673

We turn now to respondent's request that damages be imposed against petitioner under section 6673, which provides that damages may be awarded to the United States whenever it appears that a proceeding before this Court has been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceeding is frivolous or groundless. In Abrams v. Commissioner, 82 T.C. 403, 413 (1984), we imposed damages against a taxpayer who had made the same frivolous and groundless arguments as those presented by petitioner in this case. We also made it clear that tax

protester arguments of this nature are needlessly burdensome on the entire court system and will no longer be tolerated by us. While we are normally reluctant to impose section 6673 damages in fraud cases, the record in this case establishes that petitioner has had no interest in disputing either the underlying deficiencies or the additions to tax determined by respondent. While petitioner has every right to challenge respondent's assertion of fraud, her course of conduct does not convince us that she intended to do anything more than delay the payment of the tax. Therefore, in this case damages in the amount of $5,000 are awarded to the United States under section 6673.

Decision will be entered for respondent.

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JV11.7/2:1986-444

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T. C. Memo. 1986-444

UNITED STATES TAX COURT

JOHN J. O'CONNOR and YAEKO C. O'CONNOR, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 199-81. Filed September 15, 1986.

Randolph R. Slaton, for the petitioners.

Henry E. O'Neill, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WILBUR, Judge: Respondent determined the following deficiencies and additions to petitioners' Federal income taxes:

Year	Deficiency	Addition to Tax under Sec. 6653(b)[1]
1976	$ 3,544	$ 2,913
1977	5,368	3,950
1978	6,840	3,420

The issues for decision are (1) whether petitioners are entitled to certain deductions disallowed by respondent; (2) whether payments made to or on behalf of petitioners' children during the years 1976 through 1978 are deductible; and (3) whether part of the underpayment of tax for each year was due to fraud.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and the exhibits attached thereto are incorporated by this reference.

John J. O'Connor and Yaeko C. O'Connor (petitioners) resided in Honolulu, Hawaii, at the time they filed their petition in this case. During the years 1976 through 1978, John O'Connor (hereinafter petitioner) operated a publishing business as a sole proprietor under the name Mitsuba Publishing Company, (hereinafter Mitsuba). Petitioners have been in the publishing business for 25 years. They filed joint Federal income tax returns for the years 1976 through 1978. Respondent issued a timely statutory notice of deficiency on October 7, 1980.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect for the years in issue.

Petitioners' Federal income tax returns for the years 1976 through 1978 reflect the following information concerning the operation of their publishing business:

	1976	1977	1978
Gross Receipts	$145,036	$220,555	$260,012
Deductions	120,861	191,900	225,284
Net Profit	24,175	28,655	34,728

During 1976 and 1977, petitioners had unreported income of $2,736.37 and $4,411.72, respectively, representing amounts which were deposited into the bank accounts for their publishing business. Petitioners concede that these amounts were not reported as income on their Federal income tax returns for the years in issue.

Petitioners' Federal income tax returns for the 1976, 1977, and 1978 taxable years were prepared by H & R Block. For each of the years, petitioner organized the various checks involved, totaled the amounts on an adding machine, made a handwritten notation on the adding machine tape as to the category of the expense, and presented the categorized totals to H & R Block. During the years 1977 through 1979, the years for which returns for 1976 through 1978 were prepared and filed, it was H & R Block's practice in the preparation of tax returns to accept the categorization placed on a group of checks by a taxpayer.

During 1977 through 1979, H & R Block set its basic fee for the preparation of tax returns based upon the complexity of the return and the number of different forms required. If a particular taxpayer did not have his or her records organized, H & R Block would assist in the organization of the records. H & R Block charged an hourly rate for the time spent in organizing a taxpayer's records over and above the basic fee charged for the actual preparation of the return itself.

On May 21, 1978, petitioner issued check number 1658 in the amount of $46.07 payable to Sears. This check represents payment for the repair of a television. Petitioners deducted this amount on their 1978 income tax return as an "office expense."

During 1978, petitioner issued the following checks:

Date	Check No.	Amount	Payee
03/25/78	1452	$300	Co-Gard Coating
07/12/78	1800	100	United California Bank
08/18/78	1919	624	Island Sprinkler

Check number 1919 represents payment for the installation of a lawn sprinkler system at petitioners' residence; check number 1800 represents the initial deposit to open an account at United California Bank; and check number 1452 represents the purchase of roofing materials installed at petitioners' residence. Petitioners deducted the amounts of these checks on their 1978 income tax return as a "miscellaneous expense."

Petitioner issued the following checks during 1978:

Date	Check No.	Amount	Payee
07/15/78	1815	$140.60	Metropolitan Life
10/10/78	2074	45.00	State Farm Insurance
10/10/78	2078	335.90	State Farm Insurance

These checks represent the payment of premiums for personal life and automobile insurance. Petitioners deducted the amounts of these checks on their 1978 Federal income tax return as an "insurance expense." In addition, they paid personal medical insurance premiums of $1,386.30 to Kaiser. Petitioners deducted this amount both as an itemized deduction on Schedule A and as an "insurance expense" on Schedule C of their 1978 income tax return.

Petitioner issued the following checks during 1978:

Date	Check No.	Amount	Payee
1/13/78	1203	$ 580.29	Int. Rev. Service
2/11/78	1280	1,005.80	Int. Rev. Service
6/15/78	1741	95.68	H & R Block
6/19/78	1758	1,000.00	Cash
7/11/78	1784	2,635.00	Int. Rev. Service

Additionally, on September 1, 1978, petitioner issued check number 1967 in the amount of $188.82 payable to the Internal Revenue Service. This check includes $126.55 for a delinquency addition to tax, $25.31 for a failure to pay addition to tax, and $36.96 in interest with respect to the O'Connors' 1977 income tax liabilities. The checks numbered 1203, 1280, and 1784 represent payments made on petitioners' joint income tax liabilities. Petitioners deducted the amounts of these checks on their 1978 income tax return with check number 1741 being deducted on both

Schedules A and C. Respondent disallowed all but $37 (representing the interest component of check number 1967) of the claimed deductions.

During the 1977 taxable year, petitioner issued the following checks:

Date	Check No.	Amount	Payee
01/26/77	301	$ 2.00	Traffic Violations Bureau
02/26/77	359	37.00	Professional Underwriters Corp.
03/07/77	384	2.00	Traffic Violations Bureau
04/05/77	479	5.00	Traffic Violations Bureau
04/24/77	537	5.00	Traffic Violations Bureau
04/26/77	558	5.00	Traffic Violations Bureau
06/03/77	680	2.00	Traffic Bureau
06/28/77	720	2.00	Traffic Bureau
06/28/77	721	140.60	Metropolitan Life Ins.
07/15/77	793	2.00	Traffic Bureau
12/03/77	1020	5.00	Traffic Bureau

The checks to the traffic bureau represent payment of parking tickets; the check to The Metropolitan Life Insurance Company represents payment of a life insurance premium; and the check to Professional Underwriters Corporation is a travel agency bond. Petitioners deducted the amounts of these checks, plus an additional $500 for which they were unable to produce any underlying documentation, on their 1977 Federal income tax return as "miscellaneous" expenses. The total deduction (rounded to $708) was disallowed by respondent.

During 1977, petitioner issued the following checks in connection with their 1976 Federal income tax liabilities.

Date	Check No.	Amount	Payee
04/15/77	507	$1,223	Internal Revenue Service
07/11/77	778	1,059	Internal Revenue Service

In addition, they paid the Internal Revenue Service the following amounts on September 26, 1977, in connection with their 1976 income tax liabilities:

$ 85.19	Estimated tax addition to tax
105.90	Delinquency addition to tax
10.59	Failure to pay addition to tax

Petitioners also paid the Internal Revenue Service $392.25 (exclusive of interest) in 1977 in connection with their 1973 income tax liabilities. Petitioners now concede that their claimed deduction in 1977 (rounded to $2,876), relating to their Federal income tax liabilities, is not allowable.[2]

On July 29, 1976, petitioner issued check number 273 payable to "cash" in the amount of $750. The proceeds of the check were used to purchase a savings bond at the Bank of Hawaii. A receipt from the Bank of Hawaii for $750 was found in the same monthly statement as the check in question. Petitioners deducted this amount on their 1976 Federal income tax return as a "miscellaneous expense."

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[2] Petitioners also concede that their 1976 income tax return overstated allowable advertising sales agency fee deductions by $430.

During 1977, petitioner issued the following checks payable to himself:

Date	Check No.	Amount
05/06/77	578	$ 100
06/01/77	670	300
11/28/77	600	500
12/10/77	1040	100

Petitioners deducted these amounts on their 1977 Federal income tax return under the category of "office expense." They never provided respondent with any supporting documentation in connection with any of the checks payable to petitioner or to "cash."

During 1978, petitioner issued a check (number 1857) on July 31, in the amount of $1,448.21. Part of the proceeds from that check were used to purchase round-trip air fare for petitioner and his children between Honolulu, Hawaii and Portland, Oregon.[3] Petitioners deducted the entire amount represented by check number 1857 on their 1978 Federal income tax return.

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3 Petitioners apparently concede that the portion of the proceeds of check number 1857 used to purchase Mr. O'Connor's air fare represents a non-deductible personal expenditure.

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Petitioners have 5 children who were claimed as dependents during the years in issue. During 1976 through 1978, their children attended the following schools on a full-time basis.[4]

Name	1976	1977	1978
ROBERT	Univ. of Portland	Univ. of Portland	Univ. of Portland
MARIA	St. Francis H.S. & Univ. of Portland	Univ. of Portland	Univ. of Portland
DAVID	St. Louis H. S.	St. Louis H.S. & Univ. of Portland	Univ. of Portland
KATHLEEN	Sacred Heart Academy	Sacred Heart Academy	Sacred Heart Academy & Chaminade Univ.
ROSE	Sacred Heart Academy	Sacred Heart Academy	Sacred Heart Academy

Mitsuba had 12 different publications during each of the years in issue, including directories, newspapers, brochures and other publications. Mitsuba prepared all of these publications for printing, but the actual printing was done by an outside printer. Mitsuba accomplishes this by gathering the information, preparing specifications for type styles and sizes, typesetting the information, dividing the information into formats such as editorial content, advertising content, display advertising content and classified advertisement content. Following completion of the organizational process, the advertising and the

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4 The University of Portland is a private university located in Portland, Oregon; Chaminade University is a private university located in Honolulu, Hawaii; St. Francis High School, St. Louis High School and Sacred Heart Academy are all private schools located in Honolulu, Hawaii. All of these schools charge tuition.

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editorial content are designed, and the material is waxed, cut to size, and positioned, a process known as "paste-up." The material is then organized so that it will be camera ready for the printer.

During the years in issue, petitioners' children were capable of performing all of the various functions, with the exception of typesetting, involved in petitioners' publishing business. They performed delivery services, office and banking services, posting of advertising accounts, and the graphic art functions, including the paste-up process, the ordering of type, the designing of the advertising and editorial content, and the selection of photographs. The paste-up and layout work performed in petitioners' publishing business required the use of drafting boards, T-squares, and compasses. During the years in issue, petitioner did at least some of the layout and paste-up work on the publications produced in the business.

Petitioners' children had been involved in the business since they were in grammar school and some had worked for their father for as long as 10 years. The children were not paid while in grammar school, however, because they were not skilled in the business at that time.

Petitioner maintained time cards for the hours allegedly worked by the children. The time cards were not prepared by him on a contemporaneous basis. The record in this case discloses a complete lack of correlation between dates and amounts of

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payments and the hours allegedly worked by the children. Although the children purportedly worked on a regular basis, they were often paid "on demand" and, in some cases, they were paid in advance for work that was to be performed sometime in the future. These advances sometimes would coincide with a need of some type on the part of the child (e.g., tuition).

There are notations on the bottom of the time cards purportedly reflecting the total wages paid to a particular child during the year. The figures shown on the time cards, however, do not correspond to the actual payments. Although the payments to the children were allegedly not keyed to school tuition costs, the only payments made to Kathleen and Rose in 1977 were tuition payments. Likewise, two of the three payments to Maria in 1976 (representing 92 percent of the total and the only payments reflected on Maria's delinquent 1976 income tax return) were for tuition. Additionally, at least two of the four payments to David in 1977 was for school tuition.

The children allegedly earned different hourly wages (between $3 and $5) based on their age. However, the time cards for the 1978 taxable year, reflect that <u>all</u> the children earned $5 per hour despite a 6-year range in age among them. The $5 per hour wage actually represents a pay cut for Robert when compared with what he ostensibly earned in 1977. But, according to the time cards, Robert devoted more than twice as much time to his

father's business in 1978 as did his sisters Kathleen and Rose, who both ostensibly received raises while devoting substantially fewer hours in 1978 than in 1977.

The children who resided in Hawaii would allegedly work several hours every day after school in addition to sometimes working all weekend. The time cards, however, indicate no after school or weekend hours worked by David in 1977 or by Rose and Kathleen in 1978. Kathleen and Rose were the only children attending school in Hawaii for the entire 1978 taxable year. In addition, the 1977 time card for Kathleen reflects that she never worked more than one hour on any given day in 1977. The 1978 time cards for both David and Maria reflect some non-summer entries, despite the fact that both were full-time students at the University of Portland during the 1978 academic year.[5] Additionally, Maria had an infant son to care for in addition to her studies in Portland. David admitted that all of the work that he performed in his father's business was done while in Hawaii.

Petitioners' children were good students. After school, they had homework assignments which they brought home and completed. In addition, the children participated in extracurricular activities sponsored by their schools. One of their daughters was on the speech team during the years in issue,

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[5] We note that David O'Connor was at home in Hawaii with a broken ankle from February 1978 to April 1978.

and David O'Connor participated in both high school football and basketball. Football and basketball practices generally took place immediately after school and lasted approximately 2 and 1/2 hours. The children also had normal household chores in addition to their responsibilities with regard to their father's business.

The time cards in evidence in this case for 1977 and 1978 also reflect other inconsistencies. For example, Maria O'Connor's 1977 time card indicates that she worked 8 hours on June 31, 1977, even though there are only 30 days in the month of June. Additionally, despite the entry showing 8 hours of work by Maria on July 1, 1977, Exhibit 118-DN indicates that Ms. O'Connor spent part of this same day flying between Tokyo, Japan, and Honolulu, Hawaii. In addition, according to Maria's 1977 time card, she worked 144 hours out of a total 320 hours while traveling with her parents throughout the Orient.

Robert O'Connor returned to college in Portland, Oregon, on or before August 23, 1977, as evidenced by the fact that he negotiated check number 889 for $1,700 in Portland on that same date. According to Robert's 1977 time card, however, he worked a full 8 hours on both August 23rd and August 24th of 1977. In addition, seven of the eight checks payable directly to Maria in 1977 were negotiated in Oregon and 70 percent of the total payments for the year were made (according to her 1977 time card) prior to her working a single hour. Maria received all of her 1978 payments prior to July 31, 1978, even though, as of this

date, she had worked only 58 percent of the total hours shown on her time card. In addition, Robert received no payments after June 2, 1978, even though he had worked only 61 percent of his total hours by that date.

On many occasions, petitioner wrote several checks to his children on the same day for the same amount. The February 8, 1977, payments to Robert and Maria were identical, even though the two children were ostensibly compensated at different rates during 1977 and had not yet rendered any services.

Petitioners did not take any deductions for payments to anyone other than the children for the work allegedly done in the business. Petitioners' returns for 1976 through 1978, however, reflect deductions for office, shop, paste-up, and delivery expenses substantially in excess of the amounts paid to or on behalf of the children.

During the 1976, 1977, and 1978 taxable years, petitioners did not withhold Federal income tax, Social Security, or other taxes from any payments made to or on behalf of their children. Furthermore, as of the date of the petition filed in the instant case, petitioners had not filed any employment tax returns (Forms 940 and 941) reflecting their children as employees. Additionally, as of the date of the petition, none of the

children had filed any Federal income tax returns for the years in issue.[6]

During 1976, petitioners deducted the following payments made to or on behalf of their children:

Robert:

Date	Check No.	Amount	Category Deducted
01/01/76	1	$ 600	Paste-up
08/07/76	289	1,260	Office
11/18/76	175	500	Paste-up

Petitioners deducted $5,600 attributable to the checks numbered 1 and 175 as paste-up expenses. They now concede that $4,500 of the claimed deduction is not allowable. The proceeds of check number 289 were used to pay tuition expenses at the University of Portland.

Maria:

Date	Check No.	Amount	Category Deducted
07/20/76	267 (partial)	$ 204.87	Travel
08/07/76	288	1,260.00	Office
08/15/76	294	1,260.00	Office
	TOTAL:	$2,724.87	

The proceeds of the checks numbered 288 and 294 were used to pay tuition expenses at the University of Portland. On July 20, 1976, petitioner issued a check (number 267) payable to Triumph

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6 The 1976 returns for Robert and Maria, the 1977 returns for Maria, David, Kathleen and Rose, and the 1978 tax returns for Maria and David were all prepared on or about December 14, 1982, and were filed subsequent thereto.

Travel in the amount of $614.61. Of this amount, $204.87 represents one-way air fare for Maria O'Connor to fly from Honolulu, Hawaii to Portland, Oregon on August 12, 1976. The balance represents round-trip air fare for petitioner to fly between Honolulu and Portland. Petitioners deducted the entire $614.61 on their 1976 Federal income tax return as a "travel expense." Respondent disallowed the portion of the check (rounded to $205) attributable to Maria O'Connor's air fare.

During 1977, petitioners deducted the following payments made to or on behalf of their children:[7]

Robert:

Date	Check No.	Amount	Category Deducted
02/08/77	322	$ 50.00	Paste-up
03/05/77	380	50.00	Paste-up
03/21/77	417	100.00	Paste-up
04/04/77	468	100.00	Paste-up
04/26/77	554	100.00	Paste-up
05/09/77	589	150.40	Paste-up
05/23/77	634	100.00	Paste-up
07/14/77	771	100.00	Paste-up
08/20/77	889	1,700.00	Office
09/08/77	949 (partial)	248.28	Travel
12/10/77	1041	100.00	Paste-up
	TOTAL:	$2,798.68	

7 We note that the total deduction claimed on petitioners' 1977 income tax return in the category of "office expense" includes $874.98 represented by missing exhibits 30-AD and 38-AL.

The check numbered 589 represents life insurance premiums on policies covering Maria O'Connor. The proceeds of check number 889 were used to pay tuition and fees at the University of Portland.

Maria:

Date	Check No.	Amount	Category Deducted
02/08/77	323	$ 50.00	Paste-up
02/21/77	363	200.00	Paste-up
03/09/77	398	148.00	Paste-up
03/16/77	410	100.00	Paste-up
03/30/77	449	20.00	Paste-up
04/11/77	493	100.00	Paste-up
09/08/77	949 (partial)	124.28	Travel
12/03/77	1016	50.00	Paste-up
12/10/77	1043	100.00	Office
	TOTAL:	$892.28	

On September 8, 1977, petitioner issued check number 949 in the amount of $1,011.66 payable to Triumph Travel Corp. Included in this check was one-way air fare for Maria between Honolulu, Hawaii and Portland, Oregon. During 1977, Maria accompanied her parents on a trip to the Orient.

David:

Date	Check No.	Amount	Category Deducted
01/29/77	302	$ 535.00	Shop
08/20/77	890	1,700.00	Office
09/08/77	949 (partial)	124.28	Travel
12/10/77	1042	100.00	Office
	TOTAL:	$2,459.28	

The proceeds of check number 302 were used to pay tuition for David at St. Louis High School. Petitioner issued check number 949 to Triumph Travel Corp. on September 8, 1977 in the amount of $1,011.66. Of this amount, $124.28 was used to pay for David's one-way air fare between Honolulu, Hawaii and Portland, Oregon. Check number 890 represents the payment of tuition and fees on David's behalf at the University of Portland.

Kathleen:

Date	Check No.	Amount	Category Deducted
01/29/77	303	$ 310	Office

The proceeds of check number 303 were used to pay tuition at Sacred Heart Academy.

Rose:

Date	Check No.	Amount	Category Deducted
01/29/77	304	$ 310	Office
12/10/77	1081	850	Office

The proceeds of both of these checks (number 304 and 1081) were used to pay tuition at Sacred Heart Academy.

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During 1978, petitioners deducted the following payments made to or on behalf of his children:

Robert:

Date	Check No.	Amount	Category Deducted
01/03/78	1132 (partial)	$ 260.60	Travel
01/09/78	1157	1,375.00	Shop
01/26/78	1223	50.00	Office
02/17/78	1300	100.00	Shop
02/22/78	1319	137.31	Travel
02/24/78	1331	100.00	Shop
03/03/78	1363	100.00	Office
03/10/78	1383	100.00	Office
03/18/78	1408	100.00	Paste-up
03/28/78	1460	100.00	Paste-up
04/01/78	1484	100.00	Paste-up
04/08/78	1500	100.00	Shop
04/20/78	1539	200.00	Delivery
04/20/78	1546	150.40	Insurance
04/26/78	1560	100.00	Delivery
05/25/78	1674 (partial)	130.30	Travel
06/02/78	1707	100.00	Office
	TOTAL:	$3,303.61	

A portion of the proceeds of check number 1132, issued by petitioner and payable to Triumph Travel, represents payment of Robert's round-trip air fare between Honolulu, Hawaii and Portland, Oregon. Checks numbered 1319 and 1674, also issued by petitioner and payable to Triumph Travel, represent payment of Robert's one-way air fare between Honolulu, Hawaii and Portland, Oregon. Check number 1546 represents payment of premiums for personal life insurance to Metropolitan Life Insurance covering Robert O'Connor. Check number 1157 represents the payment of tuition and fees for Robert at the University of Portland.

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Maria:

Date	Check No.	Amount	Category Deducted
01/03/78	1132 (partial)	$ 290.66	Travel
01/11/78	1169	50.00	Office
01/12/78	1170	1,290.00	Office
01/24/78	1211	50.00	Office
02/18/78	1304	50.00	Office
03/03/78	1362	50.00	Shop
03/18/78	1411	148.00	Insurance
03/28/78	1451	50.00	Office
04/06/78	1494	50.00	Shop
04/14/78	1527	50.00	Shop
04/23/78	1551	100.00	Shop
05/06/78	1597	100.00	Paste-up
05/23/78	1661	100.00	Office
06/08/78	1720	100.00	Office
07/21/78	1828	100.00	Office
07/31/78	1857 (partial)	283.63	Travel
	TOTAL:	$2,862.29	

A portion of the proceeds of checks numbered 1132 and 1857, issued by petitioner and payable to Triumph Travel, represents the payment of round-trip air fare for Maria and her infant son between Honolulu, Hawaii and Portland, Oregon. The proceeds of check number 1170 were used to pay tuition for Maria O'Connor at the University of Portland. Check number 1411 represents payment of premiums for personal life insurance to Mutual of New York covering Maria O'Connor.

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David:

Date	Check No.	Amount	Category Deducted
01/03/78	1132 (partial)	$ 282.62	Travel
01/09/78	1158	1,375.00	Shop
01/26/78	1224	50.00	Office
04/01/78	1474	50.00	Office
04/17/78	1532	50.00	Office
05/15/78	1628	100.00	Delivery
05/25/78	1674 (partial)	130.30	Travel
05/26/78	1677	200.00	Delivery
07/31/78	1857 (partial)	298.66	Travel
12/25/78	2287	100.00	Misc.
	TOTAL:	$2,636.58	

Check numbers 1132 and 1857 represent, in part, payment for David's round-trip air fare between Honolulu, Hawaii and Portland, Oregon, and check number 1674 represents payment of David's one-way air fare between the same two cities. Check number 1158 represents the payment of tuition and fees for David at the University of Portland, and check number 2287 represents the payment of a Christmas "bonus" for David.

Kathleen:

Date	Check No.	Amount	Category Deducted
07/31/78	1857 (partial)	$283.63	Travel
09/05/78	1979	49.80	Misc.
12/25/78	2289	100.00	Misc.
	TOTAL:	$433.43	

Check number 1857 represents, in part, payment for Kathleen's round-trip air fare between Honolulu, Hawaii and Portland, Oregon. Check number 1979 was used to purchase class books for Kathleen at Chaminade University and check number 2289 represents the payment of a Christmas "bonus."

Rose:

Date	Check No.	Amount	Category Deducted
07/31/78	1857 (partial)	$283.63	Travel
12/25/78	2288	100.00	Misc.
	TOTAL:	$383.63	

A portion of the proceeds from check number 1857 were used to purchase round-trip air fare for Rose between Honolulu, Hawaii and Portland, Oregon, and check number 2288 represents the payment of a Christmas "bonus."

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OPINION

Issue I--Claimed Business Expense Deductions

Section 162 allows a taxpayer deductions for ordinary and necessary expenses paid or incurred during the taxable year in his trade or business. Deductions are, however, a matter of legislative grace. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). Petitioners must qualify under the specific rules and regulations imposed by Congress to be allowed business expense deductions. Deputy v. duPont, 308 U.S. 488 (1940). Respondent's notice of deficiency is presumed correct, and petitioners have the burden of proving that it is erroneous. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).[7]

A. 1977 Expenses

Petitioners offered no evidence concerning the circumstances surrounding a $500 deduction claimed in 1977 as a "miscellaneous expense" and $874.98 claimed as an "office expense" in 1977. Because petitioners have failed to provide evidence to document their assertion that such payments were ordinary and necessary business expenses paid or incurred in their publishing business, we sustain respondent's determination on this issue. Rule 142(a); Welch v. Helvering, supra. Similarly, petitioners have

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7 Unless otherwise indicated, all rule references are to the Tax Court Rules of Practice and Procedure.

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offered no evidence to support the deductibility of a $37 payment made to Professional Underwriters Corporation as a travel agency bond.

The checks made payable to the Traffic Bureau (Nos. 301, 384, 479, 537, 558, 680, 720, 793, and 1020) represent the payment of parking tickets. Respondent argues that these payments are nondeductible because of the application of section 162(f). Section 162(f) provides that no deduction "shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law." The deduction of fines and penalties uniformly has been held to frustrate state policy in a severe and direct manner by reducing the "sting" of the penalty prescribed by the state legislature. Tank Truck Rentals v. Commissioner, 356 U.S. 30, 35, 36 (1958). It is clear that the governmental statutes or ordinances violated by petitioners were intended to ensure the orderly operation of motor vehicles on the highways. To allow the fines instituted to punish violations of such statutes or ordinances to be offset or subsidized through an income tax deduction would be sharply at odds with public policy. Thus, we will sustain respondent's determination on this issue.[8]

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[8] We also note that petitioners presented no evidence regarding the connection, if any, between the traffic fines and their publishing business.

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The parties have stipulated that a $500 check to petitioner (No. 600) represents a personal draw from his business. Petitioner testified that this payment was made directly to himself and that it actually constitutes reimbursement for miscellaneous expenses that he incurred and for which he had retained receipts. We note, however, that no documentation was provided regarding these expenditures and we do not believe petitioner's claim that his receipts were lost by the Internal Revenue Service. Therefore, we sustain respondent's determination regarding this issue.

B. 1978 Taxes Expense

Petitioners deducted a total of $5,505.59 consisting of the checks numbered 1203, 1280, 1741, 1758, 1784, and 1967 on their 1978 tax returns as a "tax expense." Respondent apparently concedes that they are entitled to deduct $36.96 which represents interest paid by them on their 1977 income tax liability. We note that petitioners deducted a payment in the amount of $95.68 made to H & R Block (check number 1741) on both Schedule A and Schedule C of their 1978 tax return. Respondent concedes that this amount should properly be allowed, but solely as a Schedule A deduction. We agree with respondent. Petitioners are not permitted to also deduct this same item on Schedule C.

Respondent asserts that the deduction claimed by petitioners with regard to their payment of Federal income tax should be disallowed by virtue of section 275. We agree. Section 275

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provides that no deduction shall be allowed for the payment of Federal income taxes. Petitioners' failure to concede this adjustment is surprising in light of their concession of the same issue for 1977.

Petitioners deducted, as part of their 1978 "taxes expense", the proceeds of check number 1758 in the amount of $1,000. Check number 1758, payable to "cash", was dated June 19, 1978 and had as a notation at the bottom the word "taxes." Petitioner testified that he did not know what "taxes" were paid with the proceeds of check number 1758. He said he probably used the $1,000 to purchase a cashier's check which was in turn used to pay certain taxes. Petitioner's explanation that he may have used a cashier's check because of the large amount of money involved (i.e., "so the check isn't lost or something like that") is doubtful in view of the fact that he had used his regular checks to make other tax payments in even larger amounts. Furthermore, petitioner failed to provide us with any evidence to support the deductibility of the claimed $1,000 "taxes expense." Therefore, we sustain respondent's determination on this issue.

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C. 1978 Insurance Expense

In 1978, petitioners paid personal medical insurance premiums of $1,386.30. They deducted this amount both as an itemized deduction on Schedule A and as a business expense on Schedule C of their 1978 Federal income tax return. Respondent allowed the itemized Schedule A deduction, but obviously petitioners can only deduct this amount once. Petitioners deducted an additional $521.50 as an "insurance expense" in 1978. This amount consists of checks numbered 2074 and 2078 made payable to State Farm Insurance and check number 1815 payable to the Metropolitan Life Insurance Company. Petitioners concede that these expenditures represent the payment of premiums for personal life and automobile insurance premiums. Such personal expenditures are rendered nondeductible by virtue of section 262, which provides as follows:

SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

Accordingly, we sustain respondent's determination with respect to this issue.

D. 1976 "Miscellaneous" and 1977 "Office" Expenses

On July 29, 1976, petitioner issued check number 273 payable to "cash" in the amount of $750. The proceeds of this check were used to purchase a savings bond at the Bank of Hawaii. A receipt from the bank for $750 was found in the same monthly statement as

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the check in question. Petitioners deducted this amount on their 1976 Federal income tax return as a "miscellaneous expense." Petitioner claims that although the proceeds of check number 273 may in fact have been used to purchase a savings bond, the $750 is nonetheless deductible because the check actually represented reimbursement for expenses incurred by him in his publishing business. According to respondent, however, petitioners failed to produce any documentation in support of their reimbursement theory. We agree. Similarly, there was no documentation offered by petitioners with regard to payments of $300 and $100 made to John O'Connor in 1977 and deducted as an "office expense" (checks numbered 670 and 1040, respectively). We sustain respondent's determination as to these checks as well. Check number 578 in the amount of $100 was payable to cash and was deducted as an "office expense" on petitioners' 1977 return. As to this check, petitioners again failed to provide us with documentation to show that the proceeds were used to pay ordinary and necessary expenses for purposes of section 162. Furthermore, petitioner indicated in his testimony that this was probably a personal expenditure because the check did not have a notation on it.

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E. 1978 Office and Miscellaneous Expenses

On May 21, 1978, petitioner issued check number 1658 in the amount of $46.07. Petitioners deducted this amount on their 1978 income tax return as an "office expense." The parties have stipulated that check number 1658 represents payment for the repair of a television. Respondent asserts that an expense incurred in repairing a television is inherently personal and therefore should be disallowed. We agree. See section 262.[9]

The proceeds of check number 1800 were used as the initial deposit to open a bank account at the United California Bank. Petitioners deducted this amount as a "miscellaneous expense" on their 1978 tax return. According to petitioner, the bank account was opened at United California Bank so that his business could commence work on one of petitioners' publications. Although petitioners allege that check number 1800 was used to open a new bank account, they never claimed that any business expenditures were actually made with this $100. Therefore, we sustain respondent's determination on this issue.

On March 25, 1978, petitioner issued a check (number 1452) in the amount of $300 payable to Co-Gard Coating. This check was used for the purchase of roofing materials at petitioners' residence. In addition, on August 18, 1978, petitioner issued check number 1919 in the amount of $624 payable to Island

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9 We find petitioner's explanation that the television repaired was used in his business to be both implausible and unsupported.

Sprinkler. This check was used to pay for the installation of a lawn sprinkler at petitioners' home. Both of these amounts were deducted on petitioners' 1978 income tax return as a "miscellaneous expense." Petitioners allege that they purchased an $18,000 typesetting machine which was used in their business and which was kept in the garage. According to petitioners, the roofing materials were installed over the garage so as to waterproof the area of the residence where the typesetting machine was located. The sprinkler system was purchased and installed for dust-control purposes, again in connection with the typesetting machine.

There is no documentary evidence supporting petitioners' purchase of the typesetting machine which they claim was acquired in 1978. Although petitioner stated that the machine was used in his business and that he advised his return preparer about the machine, petitioners' 1978 income tax return fails to reflect any depreciation or investment tax credit with respect to the typesetting machine. Furthermore, the expenditures relating to the roofing and sprinkler system occurred at some point prior to the acquisition of the machine. We do not think that petitioners have sustained their burden of proving that their roofing and sprinkler expenditures were related to the alleged purchase of a typesetting machine. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

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Additionally, petitioners failed to establish that their expenditures for the roofing and the sprinkler system constitute ordinary and necessary expenses paid or incurred during the taxable year in carrying on their trade or business. Expenditures constituting improvements or betterments having a useful life extending beyond the taxable year in which the expenditures were made, must be capitalized and recovered through depreciation deductions. Section 263; Section 1.263(a)-1(b), Income Tax Regs. See Hotel Sulgrave, Inc. v. Commissioner, 21 T.C. 619, 621 (1954).[10]

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Sec. 263(a) provides in part as follows:

SEC. 263. CAPITAL EXPENDITURES.

(a) General Rule.--No deduction shall be allowed for--

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *

Section 1.263(a)-1(b) of the Income Tax Regs., provides in part as follows:

(b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph. * * *

Issue II--Claimed Business Expense Deductions for Payments Made to or on Behalf of Petitioners' Children

We next consider the issue of whether certain payments made to or on behalf of petitioners' children during the years 1976 through 1978 constitute deductible business expenses. Section 162(a)(1) provides that a deduction shall be allowed for ordinary and necessary business expenses paid or incurred during the taxable year including reasonable salaries. Compensation is deductible under section 162(a)(1) only if it is (1) reasonable in amount, (2) based on services actually rendered, and (3) paid or incurred. See section 1.162-7(a), Income Tax Regs.

Respondent has disallowed these claimed compensation deductions maintaining that petitioners are attempting to claim deductions for the personal support of their children. Petitioners assert that the payments represent compensation paid to their children in the operation of their publishing business. Respondent does concede that petitioners would be entitled to a deduction for reasonable wages paid to their children for personal service actually rendered as bona fide employees in the conduct of a petitioners' trade or business. See Rev. Rul. 72-23, 1972-1 C.B. 43.

Whether amounts paid as compensation are reasonable and whether the amounts represent payments purely for services rendered are questions of fact to be resolved on the basis of all the surrounding facts and circumstances. Eller v. Commissioner,

77 T.C. 934, 962 (1981); Levenson & Klein, Inc. v. Commissioner, 67 T.C. 694, 711 (1977). The burden of proof as to these issues is on petitioners. Botany Worsted Mills v. United States, 278 U.S. 282, 289-290 (1929); Rule 142(a). The fact that payments are made to petitioners' minor children does not preclude their deductibility. Denman v. Commissioner, 48 T.C. 439, 448-451 (1967).

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During the 3 years in issue, petitioners deducted the following payments made to or on behalf of their children:[11]

	Amount
1976	
Robert	$2,360.00
Maria	2,724.87
	$5,084.87
1977	
Robert	$2,798.68
Maria	892.28
David	2,459.28
Kathleen	310.00
Rose	1,160.00
	$7,620.24
1978	
Robert	$3,303.61
Maria	2,862.29
David	2,636.58
Kathleen	433.43
Rose	383.63
	$9,619.54

Petitioner testified that he considered the children to be his employees and that they were paid an hourly wage. He also testified that he maintained contemporaneous time records reflecting the number of hours worked by each child, and the rate of compensation paid. However, the record here discloses a complete lack of correlation between the dates and amounts of payments and the hours allegedly worked by the children.

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11 It should be noted that petitioners also deducted payments to Metropolitan Life Insurance Company of $140.60 (check no. 721 and 1815) in 1977 and 1978 as "Miscellaneous" and "Insurance" expenses. We understand from petitioner's testimony that these payments represent life insurance premiums on petitioners' children.

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Petitioner often paid the children large sums in advance for work that had not yet been performed. Although petitioner testified that the payments were not based on school tuition expenses, the only payments made to Kathleen and Rose in 1977 were for tuition payments, and 92 percent of the total and the only payments reflected on Maria's delinquent 1976 income tax return were for tuition. In addition, two of the four payments made to David in 1977 (representing 91 percent of the total) were for school tuition.

Petitioner testified that the notations made at the bottom of the time cards reflected the total wages paid to that particular child during that year. However, the figures shown on the cards do not correspond to the actual payments. Furthermore, an entirely different set of figures is found on the delinquent returns filed by the O'Connor children. Petitioner also testified that the children earned different hourly wages based on their age. But, the time cards for 1978 reflect that all of petitioners' children were compensated at the rate of $5 per hour despite a 6-year range in age among them.[12]

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We note that the $5 per hour represents a pay cut for son Robert over what he ostensibly earned in 1977, despite the fact that, according to the time cards, he devoted over twice as much time to his father's business in 1978. On the other hand, Kathleen and Rose received raises in 1978 while devoting substantially less time than in 1977.

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Petitioner testified that the children who resided in Hawaii worked several hours each day after finishing school and sometimes worked all weekend. The time cards, however, show no after-school or weekend hours worked by David in 1977 or by Rose and Kathleen in 1978. Kathleen and Rose were the only children attending school in Hawaii for the entire 1978 taxable year.

The 1977 time card for Kathleen indicates that she did not work more than a single hour on any given day in 1977. Petitioner's claim that his children worked several hours each day following school lacks credibility in light of the time demands imposed on the children by homework assignments and normal household chores. One of his daughters was on a speech team during the years in issue, and David participated in both football and basketball while he was in high school. Football and basketball practices generally took place immediately after school and lasted approximately 2 and one-half hours.

Although it may have been theoretically possible for the children to perform certain tasks in their father's business while they were traveling or on the mainland at college, all of the time-consuming lay-out, paste-up, and production work was performed at petitioners' residence in Hawaii. Furthermore, there was no evidence presented by petitioners that <u>any</u> work was actually performed outside Hawaii. Thus, all of the entries on the time cards reflecting hours worked on dates when the children were traveling or in Portland at college are suspect. For

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example, Maria's 1977 time card reflects that she worked 8 hours on July 1, 1977, even though she spent a portion of that same day flying between Tokyo, Japan, and Honolulu, Hawaii. In addition, according to Maria's time card, out of a total of 320 hours ostensibly worked by her in 1977, 144 hours were worked during the period that she was traveling with her parents in the Orient. Petitioner testified that all of the payments to Maria in 1977 were for "paste-up" work which is clearly not the type of work which could be performed while traveling.

David's 1977 time card reflects that he worked half days on Saturdays during the same period that he was attending college on a full-time basis in Oregon and working at the University of Portland. David testified, however, that whatever work he did for his father was performed while at home in Hawaii. The non-summer entries on Maria's time cards are also suspicious because she too was a full-time student in Oregon during all of 1977 and 1978. Maria also had an infant son to care for in addition to her studies at the university.

Robert's 1977 time card contains similar discrepancies. He returned to college in Portland, Oregon, no later than August 23, 1977, as evidenced by the fact that he negotiated check number 889 for $1,700 in Portland on August 23, 1977. Yet his 1977 time card shows that he worked 8 hours on both August 23 and 24.

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Additionally, Robert's 1978 time card reflects that he worked 8 hours on April 26 and 27, even though he spent at least a portion of April 26 flying from Honolulu to Portland.

Virtually all the checks payable directly to Maria in 1977 were negotiated in Oregon and, according to her 1977 time card, 70 percent of the total payments she received in that year were made prior to her working a single hour. Similarly, in 1978, Maria received all of her payments prior to July 31, 1978, even though she had worked only 58 percent of the total hours shown on her timecard as of that date. In addition, Robert received no payments after June 2, 1978, even though he had only worked 61 percent of his total hours as of that time.

As previously stated, compensation is deductible under section 162(a)(1) only if it is based on services actually rendered. Here there is serious doubt as to whether the payments made to or on behalf of the children reflected actual services performed by them. The payments made to them certainly do not correspond with the actual services performed, and on many occasions petitioner wrote several checks to his children on the same day for identical amounts. For example, the February 8, 1977 payments made to Robert and Maria were exactly the same, despite the fact that Robert and Maria were ostensibly compensated at different rates during 1977 and had not yet rendered any services.

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Three checks were prepared by petitioner on December 25, 1978, in the amount of $100 each payable to David, Kathleen, and Rose. Although these checks appear to be Christmas gifts, petitioners sought to deduct these checks as "miscellaneous" expenses. Petitioner testified that these three checks were intended to represent bonuses for work performed during the preceding year. Such assertion, however, is unlikely in light of the fact that, according to their 1978 time cards, Kathleen and Rose had not performed any services for the last 4 months of that year.

While petitioners claim that they considered their children to be employees, the objective evidence clearly indicates otherwise. Petitioners failed to withhold income taxes from the alleged wages paid to the children as required by section 3402(a).[13] They also failed to withhold Social Security taxes from the payments in question. Petitioner testified that he believed that he was exempt from having to withhold Social Security because his children were full-time students. Presumably, he was referring to section 3121(b)(3)(A) which excludes from the definition of "wages" for social security tax

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13 Sec. 3402(a) provides in part as follows:

SEC. 3402. INCOME TAX COLLECTED AT SOURCE.

(a) In General.--Except as otherwise provided in this section, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary.
* * *

purposes payments for "service performed by a child under the age of 21 in the employ of his father or mother." Section 3121(b)(3)(A). We note that petitioners failed to withhold social security taxes from the payments to Robert in 1977 and 1978 and Maria in 1978 even after their 21st birthdays. These factors have been previously cited by this Court as grounds for negating a claim that payments made to a taxpayer's minor children constituted payments for bona fide business employment. See Hill v. Commissioner, T.C. Memo. 1982-143, and Furmanski v. Commissioner, T.C. Memo. 1974-47.

It is also clear that the O'Connor children did not regard the payments they received from their father as compensation. They failed to file Federal income tax returns for the years in issue as required by section 6012(a)(1) until after the petition was filed in the instant case. Robert, who received the largest share of these payments, still had not filed a tax return as of the time this case came to trial.[14] David acknowledged in his testimony that his 1978 tax return did not reflect the payments he received from his parents. David also testified that his delinquent filing of his 1978 return was in no way prompted by his parents' pending case before this Court. We think this unlikely since David prepared and submitted to the Internal

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14 We note that only Kathleen in 1977 and Kathleen and Rose in 1978 were exempt from the filing requirement due to the fact that the amount of "wages" they received during those years did not exceed $750.

Revenue Service a sworn, notarized affidavit dated July 1, 1981, which dealt specifically with the employment compensation issue in dispute in this case.

It is clear from the record that there are glaring contradictions regarding the nature of the employment agreement, if any, between petitioner and his children, and the nature of the services performed. It is indeed difficult to believe that virtually all of the production work for a business grossing $145,036, $220,555, and $260,012 during the years in issue was performed during after-school and weekend hours by the children residing in Hawaii and during summer vacations by the children attending college in Oregon. The only rational conclusion that we can draw is that petitioner must have handled a much larger share of the production work than he now admits. Moreover, there is no evidence in the record to indicate that Mrs. O'Connor did not assist her husband in the family business.

Petitioners have not presented this Court with any credible evidence upon which we can determine the precise nature of the services rendered by the children, the number of hours of labor involved, or the reasonable value of the work performed.[15] We do believe, however, that the children performed some services in connection with petitioners' publishing business. Therefore,

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15 We note that there were no time cards provided for the 1976 taxable year. In addition, the time cards for 1977 and 1978 quite clearly had not been completed contemporaneously and, as shown above, were riddled with contradictions and inconsistencies.

exercising our best judgment and bearing heavily against petitioners whose inexactitude is of their own making, we find the reasonable value of the services performed by the children to be equal to 20 percent of the amounts claimed by petitioners on their Federal income tax returns for the years in issue. Thus, we will allow a deduction under section 162 only to that extent. Cohan v. Commissioner, 39 F.2d 540, 543-44 (2d Cir. 1930).

Issue III--Section 6653(b) Additions to Tax for Fraud

The final issue is whether petitioners are liable for the addition to tax under section 6653(b) for fraud.[16] Whether a taxpayer acted fraudulently is determined on the basis of all the facts and circumstances. Stratton v. Commissioner, 54 T.C. 255, 284 (1970). Respondent bears the burden of proving, by clear and convincing evidence, that part of the underpayment of tax in each year was due to fraud. Section 7454(a); Rule 142(b). This burden is satisfied if it is shown that the taxpayer "intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes."

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16 Sec. 6653(b) provides as follows:

SEC. 6653. FAILURE TO PAY TAX.

* * *

(b) Fraud.--If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. In the case of income taxes and gift taxes, this amount shall be in lieu of any amount determined under subsection (a). In the case of a joint return under section 6013, this subsection shall not apply with respect to the tax of a spouse unless some part of the underpayment is due to the fraud of such spouse.

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Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983); Stoltzfus v. United States, 398 F.2d 1002 (3d Cir. 1968). The existence of fraud is a question of fact to be gleaned from a consideration of the entire record. Gajewski v. Commissioner, 67 T.C. 181 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Fraud will never be presumed. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). The fraudulent intent, however, may be proved by circumstantial evidence emanating from the taxpayer's entire course of conduct. Rowlee v. Commissioner, supra at 1123; Stone v. Commissioner, 56 T.C. 213, 223-224 (1971). The taxpayer's entire course of conduct may establish the requisite fraudulent intent. Stone v. Commissioner, supra at 223-224. Otsuki v. Commissioner, 53 T.C. 96, 105-106 (1969).

We believe that the facts in this case clearly and convincingly establish that petitioners had the intent to evade tax necessary to sustain respondent's burden of proof with respect to the section 6653(b) addition to tax for fraud.

During the taxable years involved in this case, petitioner was a highly resourceful person who was successful in his business affairs. Petitioners' income tax returns indicate that his business had gross receipts of $145,036, $220,555, and $260,012 for the taxable years 1976 through 1978, respectively. We are convinced that petitioner overstated his business deductions with a willful intent to defeat and evade tax. "It is a fair inference that petitioner, possessing the business acumen

he undoubtedly possessed, could hardly have inadvertently overstated his business expense deductions to the extent that he did." Neaderland v. Commissioner, 52 T.C. 532, 540 (1969).

Petitioners overstated their various business expenses by improperly deducting many purely personal expenditures. Petitioners, for example, sought to deduct the $750 purchase of a savings bond or bonds as a "miscellaneous expense." Additionally, in 1977, petitioners claimed Schedule C deductions for the payment of parking tickets and, in 1978, they sought to deduct the cost of repairing a television and the payment of personal automobile insurance premiums. Petitioners also deducted the amount of a check (number 1800), which was used to open up a new bank account at United California Bank. We found all of these expenditures to be purely personal in nature.[17]

Finally, as already discussed, petitioners deducted numerous personal support payments made to and on behalf of their children including expenditures for tuition, school supplies, and travel to and from school. While we acknowledge that the children did perform some work in their father's business, thus entitling petitioners to a small fractional share of the compensation

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17 We note also that during 1976 and 1977, petitioners had unreported income of $2,736.37 and $4,411.72, respectively, representing amounts which were deposited into the bank accounts for their publishing business. Petitioners now concede that these amounts were not reported as income on their income tax returns for those 2 years. Petitioners also concede that their 1976 income tax returns overstated allowable advertising sales agency fee deductions by $430.

deductions claimed, we nevertheless believe that such deductions were grossly and intentionally overstated in an attempt to subsidize nondeductible personal support expenditures.

In addition to the personal expenditures that petitioners sought to deduct during the 3 years in issue, they also attempted to take numerous erroneous deductions. Any of these deductions standing alone could be explained as being merely a result of negligence or inadvertence. In the instant case, however, a regular pattern of such erroneous deductions can be discerned--a pattern which we think is indicative of fraud.

In January and November of 1976, petitioner issued two checks payable to Robert in the amount of $600 and $500, respectively. Petitioners deducted $5,600 attributable to these two checks as a "paste-up expense" on their 1976 Federal income tax return.

Petitioners improperly deducted checks totaling $2,876 and $5,469 with regard to payments of their personal Federal income tax liabilities in 1977 and 1978, respectively. They have conceded that their 1977 deduction was in error. Part of the 1978 deduction consists of a check (number 1758) made payable to cash in the amount of $1,000. Petitioner testified that he probably used the proceeds of check number 1758 to purchase a cashier's check because he did not like to use personal checks

for such large sums. We find his explanation hard to believe because he used personal checks to make payments to the Government on other occasions in even larger amounts.

Petitioners' 1978 income tax return reflects two separate items where the same amounts were deducted twice on different schedules of their return. These consisted of a $95.68 payment to H & R Block, and $1,386.30 of personal medical insurance premiums. Both these amounts were taken as an itemized deduction on Schedule A and as a business expense on Schedule C. Petitioners were unable to offer any explanation for their numerous oversights other than their allegation that the errors were made by their return preparer without their awareness or consent.

Petitioner's explanation that the entire pattern of erroneous deductions was the fault of their return preparer is entirely belied by the evidence in the record. Petitioner testified that it was his practice to merely present all of his unorganized and uncategorized checks in a grocery bag. According to him, petitioners' return preparer organized, categorized, and judged the deductibility of each expenditure based solely on the notation appearing on the check. Mr. Leslie Nishimura, the revenue agent conducting the Internal Revenue Service's investigation, testified that the various checks he examined were organized, complete with an adding machine tape showing their various totals and a notation setting forth the category under

which the expenditure was to be deducted. According to Mr. Nishimura, the notation appeared to be in petitioner's own handwriting. He testified that he was able to recognize petitioner's handwriting because of the many invoices and checks that he had reviewed during the audit.

Petitioner was unable to offer any explanation for the numerous instances where a particular check was deducted under a category that was entirely different than its notation, or where the check bore no notation whatsoever, as shown below.

Exhibit	Amount	Notation	Category Deducted
8-H	$1,260.00	Maria O'Connor	Office
9-I	600.00	Art charges	Paste-up
31-AE	100.00	None	Office
44-AR	148.00	Maria O'Connor	Paste-up
51-AY	150.40	Robert O'Connor	Paste-up
54-BB	50.00	Art work	Paste-up
55-BC	100.00	Art charges	Paste-up
59-BG	50.00	Art work	Office
60-BH	1,290.00	Art charges	Office
61-BI	50.00	None	Office
62-BJ	50.00	None	Office
63-BK	50.00	None	Office
64-BL	50.00	Art work	Office
65-BM	100.00	Paste-up	Office
66-BN	100.00	Paste-up	Office
67-BO	50.00	Art charges	Office
68-BP	50.00	None	Office
70-BR	46.07	Television repair	Office
71-BS	100.00	None	Office
82-CD	100.00	Open Account	Miscellaneous
85-CG	100.00	None	Miscellaneous
86-CH	100.00	Christmas	Miscellaneous
87-CI	100.00	Christmas	Miscellaneous
104-CZ	100.00	Paste-up	Shop
105-DA	50.00	Paste-up	Shop
106-DB	50.00	Paste-up	Shop
107-DC	100.00	Paste-up	Shop
108-DD	50.00	Paste-up	Shop
109-DE	100.00	Paste-up	Shop

We think that if petitioners' return preparer (H & R Block) had performed the type of extensive organization and categorization functions that petitioners claim, the cost for performing these duties would certainly have been reflected as deductions on petitioners' returns. Mrs. Jean Adams, a district manager for H & R Block, testified that their charges for tax return preparation were based on the complexity of the return, the amount of work involved in the return preparation, and the number of different forms and schedules involved. A flat hourly charge, in addition to the charge for the preparation of the return, was made for any time spent by H & R Block in organizing a taxpayer's return. According to Ms. Adams, H & R Block would generally accept the categorization that a taxpayer placed on a group of checks.

The Schedule C deductions claimed on petitioners' 1976 and 1977 income tax returns totaled $120,861 and $191,900, respectively. Petitioners also claimed numerous itemized deductions during the same years. Based upon the dates of the checks in the record reflected on the Schedule C expenses alone, the number of checks involved would have exceeded 300 for 1976 and 780 for 1977. Although the 1976 return included Schedules A, B, C, D, SE, and Forms 2210 and 4798, the deduction under section 212(3) reflected on petitioners' 1977 return for 1976 return preparation was a mere $58, which amount included H & R Block's charge for preparing the state's 4 percent gross excise tax

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return. The 1977 return added two Forms 5329 to those listed above, and the total charge by H & R Block was only $95.68. Presumably these H & R Block charges also included the preparation of state income tax returns. We do not believe that such nominal charges are in any way reflective of the enormous time and effort that petitioners claim were expended by H & R Block in the preparation of their tax returns for the years in issue. We also note that all of the errors on petitioners' income tax returns imputed to H & R Block were consistently in their favor.

It is clear from this record that petitioners deducted many personal expenditures as business expenses, knowing full well that such deductions would result in a substantial understatement of their income for the taxable years 1976, 1977, and 1978. As this Court stated in Hicks Co., Inc. v. Commissioner, 56 T.C. 982, 1019, (1971), affd. 470 F.2d 87 (1st Cir. 1972):

> The imposition of the addition to tax for fraud is based upon a state of mind, which is seldom susceptible of direct proof, but must be gleaned from all the facts and circumstances in the entire record. * * *
>
> It is clear that for purposes of fraud an understatement of taxes can be accomplished by an overstatement of deductions. [Citations omitted.]

In view of all the facts in the instant case, we conclude that part of petitioners' underpayment of taxes for 1976, 1977, and 1978 was due to fraud. We do not believe that they acted innocently or in good faith or that their substantial overstatements of business expenses were the result of honest

mistakes. Neaderland v. Commissioner, 52 T.C. 532, 541 (1969). Accordingly, we hold that respondent has met his burden of proving fraud.[18]

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18. Petitioners requested an award of costs and attorney's fees pursuant to sec. 7430. Sec. 7430, however, is not applicable because the instant case was commenced prior to that section's effective date. Prior to the enactment of sec. 7430, this Court was without authority to award attorney's fees or costs. See McQuiston v. Commissioner, affd. without published opinion 711 F.2d 1064 (9th Cir. 1983); Sharon v. Commissioner, affd. per curiam 591 F.2d 1273 (9th Cir. 1978).

Although unrelated to the fraud issue, petitioners contend in their opening brief that respondent's own records reflect that there are no deficiencies due from petitioners for the years in issue, citing a Certificate of Assessments and Payments (Ex. 130-DZ) and a computer-generated letter from the Fresno Service Center (Ex. 119). According to respondent, petitioners simply misread the documents. We agree.

A Certificate of Assessments and Payments is merely a record of assessments made against a taxpayer as well as the payments made towards those assessments. Petitioners apparently fail to appreciate that the term "assessment" is a term of art with special legal implications. According to respondent, the reason that the deficiencies determined in the statutory notice are not reflected as assessments in exhibit 130-DZ is that sec. 6213(a) prohibits the Internal Revenue Service from making an assessment where "a petition has been filed with the Tax Court, until the decision of the Tax Court has become final." Exhibit 130-DZ reflects payments made by petitioners towards assessments made with regard to the tax liabilities reflected on the original returns, certain additions to tax and interest.

Contrary to petitioners' contention, exhibit 119 does not represent a concession by respondent that no deficiency exists for the 1976 taxable year. The Certificate of Assessments and Payments merely reflects that petitioners, for reasons known only to themselves, made a payment to the Internal Revenue Service on October 22, 1981 (more than 10 months after filing their petition) for the year 1976 in the amount of $194.67. Because there was no unpaid assessed liability at that time against which to apply the payment, it remained as a credit to petitioners' account until February 14, 1983. On that date, that amount, plus $14.30 in interest earned on the credit, was applied against an assessed liability with regard to petitioners' 1981 tax return.

(footnote continued)

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To reflect the concessions made by the parties and our conclusions with respect to the disputed issues,

Decision will be entered under Rule 155.

(footnote continued from previous page)
Exhibit 119 merely advises petitioners of that application of funds. It does not represent a concession of the instant case with respect to the 1976 taxable year.